Aclaris Therapeutics, Inc.
Form 10-Q
May 08, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(Mark one)

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

For the quarterly period ended March 31, 2018

OR

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

For the transition period from to

Commission File Number 001-37581

Aclaris Therapeutics, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	46-0571712
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
640 Lee Road, Suite 200 Wayne, PA	19087
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (484) 324 7933

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b 2 of the Securities Exchange Act of 1934:

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

The number of outstanding shares of the registrant's common stock, par value $0.00001 per share, as of the close of business on May 7, 2018 was 30,906,003.

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ACLARIS THERAPEUTICS, INC.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

ACLARIS THERAPEUTICS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except share and per share data)

	March 31, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 54,881	$ 20,202
Marketable securities	132,096	173,655
Accounts receivable, net	529	481
Prepaid expenses and other current assets	4,750	5,883
Total current assets	192,256	200,221
Marketable securities	—	14,997
Property and equipment, net	2,191	2,159
Intangible assets	7,330	7,349
Goodwill	18,504	18,504
Other assets	341	279
Total assets	$ 220,622	$ 243,509
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,155	$ 7,822
Accrued expenses	5,668	4,940
Total current liabilities	13,823	12,762
Contingent consideration	5,244	4,378
Other liabilities	534	558
Deferred tax liability	549	549
Total liabilities	20,150	18,247
Stockholders' Equity:		
Preferred stock, $0.00001 par value; 10,000,000 shares authorized and no shares issued or outstanding at March 31, 2018 and December 31, 2017	—	—
	—	—

Common stock, $0.00001 par value; 100,000,000 shares authorized at March 31, 2018 and December 31, 2017; 30,905,629 and 30,856,505 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively		
Additional paid in capital	390,464	384,943
Accumulated other comprehensive loss	(328)	(246)
Accumulated deficit	(189,664)	(159,435)
Total stockholders' equity	200,472	225,262
Total liabilities and stockholders' equity	$ 220,622	$ 243,509

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

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ACLARIS THERAPEUTICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(UNAUDITED)

(In thousands, except share and per share data)

	Three Months Ended March 31,	
	2018	2017
Revenue	$ 1,118	$ —
Cost of revenue	967	—
Gross profit	151	—
Operating expenses:		
Research and development	13,606	7,772
Sales and marketing	11,233	1,438
General and administrative	6,260	3,720
Total operating expenses	31,099	12,930
Loss from operations	(30,948)	(12,930)
Other income, net	719	371
Net loss	$ (30,229)	$ (12,559)
Net loss per share, basic and diluted	$ (0.98)	$ (0.48)
Weighted average common shares outstanding, basic and diluted	30,885,928	26,080,806
Other comprehensive loss:		
Unrealized loss on marketable securities, net of tax of $0	$ (65)	$ (52)
Foreign currency translation adjustments	(17)	72
Total other comprehensive (loss) income	(82)	20
Comprehensive loss	$ (30,311)	$ (12,539)

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

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ACLARIS THERAPEUTICS, INC.

CONDENSED CONSOLIDATED STATEMENT OF

STOCKHOLDERS' EQUITY

(UNAUDITED)

(In thousands, except share data)

	Common Stock		Additional Paid in Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity
	Shares	Par Value				
Balance at December 31, 2017	30,856,505	$ —	$ 384,943	$ (246)	$ (159,435)	$ 225,262
Exercise of stock options and vesting of RSUs	49,124	—	378	—	—	378
Unrealized loss on marketable securities	—	—	—	(65)	—	(65)
Foreign currency translation adjustment	—	—	—	(17)	—	(17)
Stock-based compensation expense	—	—	5,143	—	—	5,143
Net loss	—	—	—	—	(30,229)	(30,229)
Balance at March 31, 2018	30,905,629	$ —	$ 390,464	$ (328)	$ (189,664)	$ 200,472

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

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ACLARIS THERAPEUTICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In thousands)

	Three Months Ended March 31,	
	2018	2017
Cash flows from operating activities:		
Net loss	$ (30,229)	$ (12,559)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	222	50
Stock-based compensation expense	5,143	3,153
Change in fair value of contingent consideration	866	—
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	1,022	(2,597)
Accounts payable	316	831
Accrued expenses	788	(1,537)
Net cash used in operating activities	(21,872)	(12,659)
Cash flows from investing activities:		
Purchases of property and equipment	(298)	(195)
Purchases of marketable securities	(35,614)	(17,158)
Proceeds from sales and maturities of marketable securities	92,105	23,309
Net cash provided by investing activities	56,193	5,956
Cash flows from financing activities:		
Capital lease payments	(36)	—
Proceeds from the exercise of employee stock options	394	209
Net cash provided by financing activities	358	209
Net increase (decrease) in cash and cash equivalents	34,679	(6,494)
Cash and cash equivalents at beginning of period	20,202	30,171
Cash and cash equivalents at end of period	$ 54,881	$ 23,677
Supplemental disclosure of non-cash investing and financing activities:		
Additions to property and equipment included in accounts payable	$ 210	$ 91
Offering costs included in accounts payable	$ 20	$ —

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

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ACLARIS THERAPEUTICS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

1. Organization and Nature of Business

Aclaris Therapeutics, Inc. was incorporated under the laws of the State of Delaware in 2012. In July 2015, Aclaris Therapeutics International Limited ("ATIL") was established under the laws of the United Kingdom as a wholly-owned subsidiary of Aclaris Therapeutics, Inc. In March 2016, Vixen Pharmaceuticals, Inc. ("Vixen") became a wholly-owned subsidiary of Aclaris Therapeutics, Inc. (see Note 12). In August 2017, Aclaris Life Sciences Inc. (formerly known as Confluence Life Sciences Inc.) ("Confluence") was acquired by Aclaris Therapeutics, Inc. and became a wholly-owned subsidiary thereof (see Note 3). Aclaris Therapeutics, Inc., ATIL, Vixen and Confluence are referred to collectively as the "Company". The Company is a dermatologist-led biopharmaceutical company focused on identifying, developing and commercializing innovative and differentiated therapies to address significant unmet needs in medical and aesthetic dermatology. The Company's lead drug, ESKATA (hydrogen peroxide) Topical Solution, 40% (w/w) ("ESKATA"), is a proprietary high concentration formulation of hydrogen peroxide that the Company is commercializing as an office-based prescription treatment for raised seborrheic keratosis ("SK"), a common non malignant skin tumor. The Company submitted a New Drug Application ("NDA") for ESKATA to the U.S. Food and Drug Administration ("FDA") in February 2017, and it was approved in December 2017. The Company launched commercial product sales of ESKATA in May 2018.

Liquidity

The Company's condensed consolidated financial statements have been prepared on the basis of continuity of operations, realization of assets and the satisfaction of liabilities in the ordinary course of business. At March 31, 2018, the Company had cash, cash equivalents and marketable securities of $186,977 and an accumulated deficit of $189,664. Since inception, the Company has incurred net losses and negative cash flows from its operations. Prior to the acquisition of Confluence in August 2017, the Company had never generated any revenue. There can be no assurance that profitable operations will ever be achieved, and, if achieved, will be sustained on a continuing basis. In addition, development activities, clinical and preclinical testing, and commercialization of the Company's products will require significant additional financing. The future viability of the Company is dependent on its ability to generate cash from operating activities or to raise additional capital to finance its operations. The Company's failure to raise capital as and when needed could have a negative impact on its financial condition and ability to pursue its business strategies.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The financial statements include the consolidated accounts of the Company and its wholly-owned subsidiaries, ATIL, Confluence and Vixen. All significant intercompany transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting periods. Significant estimates and assumptions reflected in these financial statements include, but are not limited to, research and development

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expenses, contingent consideration and the valuation of stock-based awards. Estimates are periodically reviewed in light of changes in circumstances, facts and experience. Actual results could differ from the Company's estimates.

Unaudited Interim Financial Information

The accompanying condensed consolidated balance sheet as of March 31, 2018, the condensed consolidated statements of operations and comprehensive loss for the three months ended March 31, 2018 and 2017, the condensed consolidated statement of stockholders' equity for the three months ended March 31, 2018, and the condensed consolidated statements of cash flows for the three months ended March 31, 2018 and 2017 are unaudited. The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited annual financial statements contained in the Company's annual report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on March 12, 2018 and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary for the fair statement of the Company's financial position as of March 31, 2018, the results of its operations and comprehensive loss for the three months ended March 31, 2018 and 2017 and its cash flows for the three months ended March 31, 2018 and 2017. The condensed consolidated balance sheet data as of December 31, 2017 was derived from audited financial statements but does not include all disclosures required by GAAP. The financial data and other information disclosed in these notes related to the three months ended March 31, 2018 and 2017 are unaudited. The results for the three months ended March 31, 2018 are not necessarily indicative of results to be expected for the year ending December 31, 2018, any other interim periods, or any future year or period. The unaudited interim financial statements of the Company included herein have been prepared, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted from this report, as is permitted by such rules and regulations. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the year ended December 31, 2017 included in the Company's annual report on Form 10-K filed with the SEC on March 12, 2018.

Significant Accounting Policies

The Company's significant accounting policies are disclosed in the audited consolidated financial statements for the year ended December 31, 2017 included in the Company's annual report on Form 10-K filed with the SEC on March 12, 2018. Since the date of such financial statements, there have been no changes to the Company's significant accounting policies other than those noted below.

In February 2017, the Company paid a $2.0 million PDUFA fee to the FDA in conjunction with the filing of its NDA for ESKATA. The Company requested a waiver and refund of this PDUFA fee, which was approved by the FDA in December 2017, and was received by the Company in January 2018.

Revenue Recognition

The Company accounts for revenue in accordance with Accounting Standards Codification ("ASC") Topic 606, Revenue from Contracts with Customers. Under Topic 606, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services.

To determine revenue recognition in accordance with ASC Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) performance obligations are satisfied. At contract inception, the Company assesses the goods or services promised within a contract with a customer to identify the performance obligations, and to determine if they are distinct. The Company recognizes the revenue that is allocated to each distinct performance obligation when (or as) that performance obligation is satisfied. The Company only recognizes revenue when collection of the consideration it is

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entitled to under a contract with a customer is probable.

The Company earns revenue from the provision of laboratory services to clients through Confluence, its wholly-owned subsidiary. Laboratory service revenue is generally evidenced by contracts with clients which are on an agreed upon fixed-price, fee-for-service basis and are generally billed on a monthly basis in arrears for services rendered. Revenue related to these contracts is generally recognized as the laboratory services are performed, based upon the rates specified in the contracts. Under ASC Topic 606, the Company elected to apply the "right to invoice" practical expedient when recognizing laboratory service revenue. The Company recognizes laboratory service revenue in the amount to which it has the right to invoice.

The Company also receives revenue from grants under the Small Business Innovation Research program of the National Institutes of Health ("NIH"). The Company, through its Confluence subsidiary, currently has two active grants from NIH which are related to early-stage research. The Company recognizes revenue related to these grants as amounts become reimbursable under each grant, which is generally when research is performed and the related costs are incurred.

Intangible Assets

Intangible assets include both finite-lived and indefinite-lived assets. Finite-lived intangible assets are amortized over their estimated useful life based on the pattern over which the intangible assets are consumed or otherwise used up. If that pattern cannot be reliably determined, the straight-line method of amortization is used. Finite-lived intangible assets consist of a research technology platform the Company acquired through the acquisition of Confluence. Indefinite-lived intangible assets consist of an in-process research and development ("IPR&D") drug candidate acquired through the acquisition of Confluence. IPR&D assets are considered indefinite-lived until the completion or abandonment of the associated research and development efforts. The cost of IPR&D assets is either amortized over their estimated useful life beginning when the underlying drug candidate is approved and launched commercially, or expensed immediately if development of the drug candidate is abandoned.

Finite-lived intangible assets are tested for impairment when events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. Indefinite-lived intangible assets are tested for impairment at least annually, which the Company performs during the fourth quarter, or when indicators of an impairment are present. The Company recognizes impairment losses when and to the extent that the estimated fair value of an indefinite-lived intangible asset is less than its carrying value.

Goodwill

Goodwill is not amortized, but rather is subject to testing for impairment at least annually, which the Company performs during the fourth quarter, or when indicators of an impairment are present. The Company considers each of its operating segments, dermatology therapeutics and contract research, to be a reporting unit since this is the lowest level for which discrete financial information is available. The Company has attributed the full amount of the goodwill acquired with Confluence, or $18,504, to the dermatology therapeutics segment. The annual impairment test performed by the Company is a qualitative assessment based upon current facts and circumstances related to operations of the dermatology therapeutics segment. If the qualitative assessment indicates an impairment may be present, the Company would perform the required quantitative analysis and an impairment charge would be recognized to the extent that the estimated fair value of the reporting unit is less than its carrying amount. However, any loss recognized would not exceed the total amount of goodwill allocated to that reporting unit.

Contingent Consideration

The Company initially recorded the contingent consideration related to future potential payments based upon the achievement of certain development, regulatory and commercial milestones, resulting from the acquisition of Confluence, at its estimated fair value on the date of acquisition. Changes in fair value reflect new information about the likelihood of

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the payment of the contingent consideration and the passage of time. Future changes in the fair value of the contingent consideration, if any, will be recorded as income or expense in the Company's consolidated statement of operations.

Segment Data

The Company operates in two segments, dermatology therapeutics and contract research, for the purposes of assessing performance and making operating decisions. The Company's dermatology therapeutics segment, which did not generate any revenue through March 31, 2018, is focused on identifying, developing and commercializing innovative and differentiated therapies to address significant unmet needs in medical and aesthetic dermatology and immunology. The Company's contract research segment is focused on providing laboratory services under contract research arrangements to pharmaceutical and biotech companies looking to supplement their research and development efforts with difficult-to-execute specialty skills and programs.

Recently Issued Accounting Pronouncements

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-01, Business Combinations-Clarifying the Definition of a Business (Topic 805). The amendments in this ASU provide a screen to determine when a set of acquired assets and/or activities is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired, or disposed of, is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. The amendments in this ASU will reduce the number of transactions that meet the definition of a business. ASU 2017-01 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within those years, and early adoption will be permitted. The Company adopted the provisions of this standard on January 1, 2018, the impact of which on its consolidated financial statements was not significant.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). Under this ASU, entities should recognize revenue in an amount that reflects the consideration to which they expect to be entitled to in exchange for goods and services provided. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017. The Company adopted the provisions of this standard on January 1, 2018, using the modified retrospective transition method. The Company did not recognize any transition adjustments as a result of adopting ASU 2014-09 and, accordingly, comparative information has not been restated for the periods reported.

3. Acquisition of Confluence

In August 2017, the Company acquired Confluence, at which time, Confluence became a wholly-owned subsidiary of the Company. The Company gave aggregate consideration with a fair value of $24,322 to the equity holders of Confluence. The Company also agreed to pay the Confluence equity holders contingent consideration of up to $80,000, based upon the achievement of certain development, regulatory and commercial milestones, including $2,500 of which may be paid in shares of the Company's common stock upon the achievement of a specified development milestone. In addition, the Company has agreed to pay the Confluence equity holders specified future royalty payments calculated as a low single-digit percentage of annual net sales, subject to specified reductions, limitations and other adjustments, until the date that all of the patent rights for that product have expired, as determined on a country-by-country and product-by-product basis or, in specified circumstances, ten years from the first commercial sale of such product.

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The following table summarizes the fair value of total consideration given to the Confluence equity holders in connection with the acquisition:

Cash consideration paid	$ 10,269
Aclaris common stock issued	9,675
Contingent consideration	4,378
Total fair value of consideration to Confluence equity holders	$ 24,322

The Company accounted for the acquisition of Confluence as a business combination using the acquisition method of accounting. Under the acquisition method of accounting, the assets acquired and liabilities assumed in this transaction were recorded at their respective fair values on the date of acquisition using assumptions that are subject to change. The Company expects to finalize its allocation of the purchase price upon the finalization of valuations for the identified intangible assets, final resolution of the post-closing working capital adjustment and certain tax accounts that are based on the best estimates of management. The completion and filing of federal and state tax returns for the acquired entity may result in adjustments to the carrying value of assets and liabilities.

The following supplemental unaudited pro forma information presents the Company's financial results, for the periods presented, as if the acquisition of Confluence had occurred on January 1, 2017. This supplemental unaudited pro forma financial information has been prepared for comparative purposes only, and is not necessarily indicative of what actual results would have been had the acquisition of Confluence occurred on January 1, 2017, nor is this information indicative of future results.

	Three Months Ended March 31,	
	2018	2017
Revenue	$ 1,118	$ 1,236
Gross profit	151	563
Total operating expenses	31,099	13,607
Net loss	(30,229)	(12,673)

The supplemental unaudited pro forma financial results for the three months ended March 31, 2017 include adjustments to exclude $301 of revenue billed to the Company by Confluence. The supplemental unaudited pro forma financial results for the three months ended March 31, 2017 also includes an adjustment for amortization expense related to the other intangible assets acquired.

4. Fair Value of Financial Assets and Liabilities

The following tables present information about the Company's assets and liabilities, which are measured at fair value on a recurring basis and indicate the level of the fair value hierarchy utilized to determine such fair values:

	March 31, 2018			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents	$ 36,035	$ 17,471	$ —	$ 53,506
Marketable securities	—	132,096	—	132,096
Total Assets	$ 36,035	$ 149,567	$ —	$ 185,602
Liabilities:				
Acquisition-related contingent consideration	$ —	$ —	$ 5,244	$ 5,244
Total liabilities	$ —	$ —	$ 5,244	$ 5,244

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	December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents	$ 19,339	$ —	$ —	$ 19,339
Marketable securities	—	188,652	—	188,652
Total Assets	$ 19,339	$ 188,652	$ —	$ 207,991
Liabilities:				
Acquisition-related contingent consideration	$ —	$ —	$ 4,378	$ 4,378
Total liabilities	$ —	$ —	$ 4,378	$ 4,378

As of March 31, 2018 and December 31, 2017, the Company's cash equivalents consisted of investments with maturities of less than three months and included a money market fund, which was valued based upon Level 1 inputs, and commercial paper and asset-backed securities, which were valued based upon Level 2 inputs. In determining the fair value of its Level 2 investments the Company relied on quoted prices for identical securities in markets that are not active. These quoted prices were obtained by the Company with the assistance of a third-party pricing service based on available trade, bid and other observable market data for identical securities. On a quarterly basis, the Company compares the quoted prices obtained from the third-party pricing service to other available independent pricing information to validate the reasonableness of those quoted prices. The Company evaluates whether adjustments to third-party pricing is necessary and, historically, the Company has not made adjustments to the quoted prices obtained from the third-party pricing service. During the three months ended March 31, 2018 and the year ended December 31, 2017, there were no transfers between Level 1, Level 2 and Level 3.

As of March 31, 2018 and December 31, 2017, the fair value of the Company's available for sale marketable securities by type of security was as follows:

	March 31, 2018			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Marketable securities:				
Corporate debt securities	$ 36,733	$ —	$ (115)	$ 36,618
Commercial paper	48,610	—	(3)	48,607
Asset-backed securities	21,003	—	(35)	20,968
U.S. government agency debt securities	25,985	—	(82)	25,903
Total marketable securities	$ 132,331	$ —	$ (235)	$ 132,096

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Marketable securities:				
Corporate debt securities	$ 37,401	$ —	$ (68)	$ 37,333
Commercial paper	85,202	—	—	85,202
Asset-backed securities	16,708	—	(13)	16,695
U.S. government agency debt securities	49,511	—	(89)	49,422
Total marketable securities	$ 188,822	$ —	$ (170)	$ 188,652

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5. Property and Equipment, Net

Property and equipment, net consisted of the following:

	March 31, 2018	December 31, 2017
Computer equipment	$ 817	$ 650
Manufacturing equipment	562	511
Lab equipment	721	721
Furniture and fixtures	524	327
Leasehold improvements	250	430
Property and equipment, gross	2,874	2,639
Accumulated depreciation	(683)	(480)
Property and equipment, net	$ 2,191	$ 2,159

Depreciation expense was $203 and $50 for the three months ended March 31, 2018 and 2017, respectively.

6. Accrued Expenses

Accrued expenses consisted of the following:

	March 31, 2018	December 31, 2017
Employee compensation expenses	$ 2,999	$ 3,010
Research and development expenses	1,362	627
Sales and marketing expenses	521	39
Payable to NST	—	590
Vixen contract payable	100	100
Capital leases, current portion	142	142
Other	544	432
Total accrued expenses	$ 5,668	$ 4,940

7. Stockholders' Equity

Preferred Stock

As of March 31, 2018 and December 31, 2017, the Company's amended and restated certificate of incorporation authorized the Company to issue 10,000,000 shares of undesignated preferred stock. No shares of preferred stock were outstanding as of March 31, 2018 or December 31, 2017.

Common Stock

As of March 31, 2018 and December 31, 2017, the Company's amended and restated certificate of incorporation authorized the Company to issue 100,000,000 shares of $0.00001 par value common stock.

Each share of common stock entitles the holder to one vote on all matters submitted to a vote of the Company's stockholders. Common stockholders are entitled to receive dividends, as may be declared by the board of directors, if any, subject to any preferential dividend rights of any series of preferred stock that may be outstanding. No dividends have been declared through March 31, 2018.

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At-The-Market Equity Offering

In November 2016, the Company entered into an at-the-market sales agreement with Cowen and Company, LLC to sell the Company's securities under a shelf registration statement filed in November 2016. During the three months ended March 31, 2018, the Company did not issue any shares of common stock under the at-the-market sales agreement. As of March 31, 2018, the Company had issued and sold an aggregate of 635,000 shares of common stock under the at-the-market sales agreement at a weighted average price per share of $31.50, for aggregate gross proceeds of $20,003. The Company has incurred expenses of $691 in connection with the shares issued under the at-the-market sales agreement.

Public Offering of Common Stock

In August 2017, the Company entered into an underwriting agreement pursuant to which the Company issued and sold 3,747,602 shares of common stock under a registration statement on Form S-3 (the "Public Offering"), including the underwriters' partial exercise of their option to purchase additional shares. The shares of common stock were sold to the public at a price of $23.02 per share, for gross proceeds of $86,270.

The Company paid underwriting discounts and commissions of $5,176 to the underwriters in connection with the Public Offering. In addition, the Company incurred expenses of $176 in connection with the Public Offering. The net offering proceeds received by the Company, after deducting underwriting discounts and commissions and offering expenses, were $80,918.

8. Stock Based Awards

2017 Inducement Plan

In July 2017, the Company's board of directors adopted the 2017 Inducement Plan (the "2017 Inducement Plan"). The 2017 Inducement Plan is a non-shareholder approved stock plan adopted pursuant to the "inducement exception" provided under NASDAQ listing rules. The only employees eligible to receive grants of awards under the 2017 Inducement Plan are individuals who satisfy the standards for inducement grants under NASDAQ rules, generally including individuals who were not previously an employee or director of the Company. Under the terms of the 2017 Inducement Plan upon adoption, the Company may grant up to 1,000,000 shares of common stock pursuant to nonqualified stock options, stock appreciation rights, restricted stock awards, restricted stock unit ("RSU") awards, and other stock awards. The shares of common stock underlying any awards that expire, or are otherwise terminated, settled in cash or repurchased by the Company under the 2017 Inducement Plan will be added back to the shares of

common stock available for issuance under the 2017 Inducement Plan. As of March 31, 2018, 150,624 shares of common stock were available for grant under the 2017 Inducement Plan.

2015 Equity Incentive Plan

In September 2015, the Company's board of directors adopted the 2015 Equity Incentive Plan (the "2015 Plan"), and on September 16, 2015, the Company's stockholders approved the 2015 Plan. The 2015 Plan became effective in connection with the Company's initial public offering in October 2015. Beginning at the time the 2015 Plan became effective, no further grants may be made under the Company's 2012 Equity Compensation Plan, as amended and restated (the "2012 Plan"). The 2015 Plan provides for the grant of incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock awards, RSU awards, performance stock awards, cash-based awards and other stock-based awards. The number of shares initially reserved for issuance under the 2015 Plan was 1,643,872 shares of common stock. The number of shares of common stock that may be issued under the 2015 Plan will automatically increase on January 1 of each year, beginning on January 1, 2016 and ending on January 1, 2025, in an amount equal to the lesser of (i) 4.0% of the shares of the Company's common stock outstanding on December 31 of the preceding calendar year or (ii) an amount determined by the Company's board of directors. The shares of common stock underlying any awards that expire, are otherwise terminated, settled in cash or repurchased by the Company under the 2015 Plan and the 2012 Plan

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will be added back to the shares of common stock available for issuance under the 2015 Plan. As of January 1, 2018, the number of shares of common stock that may be issued under the 2015 Plan was automatically increased by 1,234,260 shares. As of March 31, 2018, 1,599,031 shares remained available for grant under the 2015 Plan.

2012 Equity Compensation Plan

Upon the 2015 Plan becoming effective, no further grants can be made under the 2012 Plan. The Company granted stock options to purchase a total of 1,140,524 shares under the 2012 Plan, of which 957,013 and 984,720 were outstanding as of March 31, 2018 and December 31, 2017, respectively. Stock options granted under the 2012 Plan vest over four years and expire after ten years. As required, the exercise price for the stock options granted under the 2012 Plan was not less than the fair value of the shares of common stock underlying the awards as determined by the Company as of the date of grant.

Stock Option Valuation

The weighted average assumptions the Company used to estimate the fair value of stock options granted were as follows:

	Three Months Ended March 31,			
	2018		2017	
Risk-free interest rate	2.61	%	2.10	%
Expected term (in years)	6.3		6.0	
Expected volatility	95.60	%	95.20	%
Expected dividend yield	0	%	0	%

The Company recognizes compensation expense for awards over their vesting period. Compensation expense for awards includes the impact of forfeitures in the period when they occur.

Stock Options

The following table summarizes stock option activity from January 1, 2018 through March 31, 2018:

	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding as of December 31, 2017	3,328,757		$ 20.69	8.28	$ 19,812
Granted	1,090,000		22.17		
Exercised	(46,700)		8.43		
Forfeited and cancelled	(25,147)		28.40		
Outstanding as of March 31, 2018	4,346,910		$ 21.15	8.60	$ 10,779
Options vested and expected to vest as of March 31, 2018	4,346,910		$ 21.15	8.60	$ 10,779
Options exercisable as of March 31, 2018	1,265,616	(1)	$ 15.33	7.55	$ 8,066

(1) All options granted under the 2012 Plan are exercisable immediately, subject to a repurchase right in the Company's favor that lapses as the option vests. This amount reflects the number of shares under options that were vested, as opposed to exercisable, as of March 31, 2018.

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The weighted average grant date fair value of stock options granted during the three months ended March 31, 2018 was $17.43 per share.

The intrinsic value of a stock option is calculated as the difference between the exercise price of the stock option and the fair value of the underlying common stock, and cannot be less than zero.

Restricted Stock Units

The following table summarizes RSU activity from January 1, 2018 through March 31, 2018:

	Number of Shares	Weighted Average Grant Date Fair Value Per Share
Outstanding as of December 31, 2017	283,553	$ 27.02
Granted	317,360	22.14
Vested	(3,150)	20.39
Forfeited and cancelled	(2,500)	23.62
Outstanding as of March 31, 2018	595,263	$ 24.46

Stock Based Compensation

The following table summarizes stock based compensation expense recorded by the Company:

	Three Months Ended March 31,	
	2018	2017
Cost of revenue	$ 176	$ —
Research and development	1,727	1,217
Sales and marketing	907	380
General and administrative	2,333	1,556
Total stock-based compensation expense	$ 5,143	$ 3,153

As of March 31, 2018, the Company had unrecognized stock based compensation expense for stock options and RSUs of $50,862 and $11,752, respectively, which is expected to be recognized over weighted average periods of 3.12 years and 3.41 years, respectively.

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9. Net Loss per Share

Basic and diluted net loss per share is summarized in the following table:

	Three Months Ended March 31,	
	2018	2017
Numerator:		
Net loss	$ (30,229)	$ (12,559)
Denominator:		
Weighted average shares of common stock outstanding	30,885,928	26,080,806
Net loss per share, basic and diluted	$ (0.98)	$ (0.48)

The Company's potentially dilutive securities, which included stock options and RSUs, have been excluded from the computation of diluted net loss per share since the effect would be to reduce the net loss per share. Therefore, the weighted average number of shares of common stock outstanding used to calculate both basic and diluted net loss per share is the same. The following table presents potential shares of common stock excluded from the calculation of diluted net loss per share for the three months ended March 31, 2018 and 2017. All share amounts presented in the table below represent the total number outstanding as of March 31, 2018 and 2017.

	Three Months Ended March 31,	
	2018	2017
Options to purchase common stock	4,346,910	2,656,941
Restricted stock unit awards	595,263	214,343
Total potential shares of common stock	4,942,173	2,871,284

10. Commitments and Contingencies

Agreements for Office Space

In November 2017, the Company entered into a sublease agreement with Auxilium Pharmaceuticals, LLC (the "Sublandlord") pursuant to which it subleases 33,019 square feet of office space for its headquarters in Wayne,

Pennsylvania. Subject to the consent of Chesterbrook Partners, LP ("Landlord") as set forth in the lease by and between them and Sublandlord, the sublease has a term that runs through October 2023. If for any reason the lease between the Landlord and Sublandlord is terminated or expires prior to October 2023, the Company's sublease will automatically terminate.

In November 2016, the Company entered into a lease agreement with a third party for additional office space in Malvern, Pennsylvania with a term ending in November 2019. The Company also occupies office and laboratory space in St. Louis, Missouri under the terms of an agreement which it entered into in January 2018 and which expires in December 2018.

Rent expense was $276 and $84 for the three months ended March 31, 2018 and 2017, respectively. The Company recognizes rent expense on a straight-line basis over the term of the lease and has accrued for rent expense incurred but not yet paid.

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As of March 31, 2018, future minimum lease payments under these agreements were as follows:

Year Ending December 31,	
2018	$ 568
2019	627
2020	589
2021	605
2022	622
Thereafter	532
Total	$ 3,543

Capital Leases for Laboratory Equipment

The Company leases laboratory equipment which is used in its laboratory space in St. Louis, Missouri under two capital lease financing arrangements which the Company entered into in August 2017 and October 2017, respectively. The capital leases have terms which end in October 2020 and December 2020, respectively.

11. Related Party Transactions

In August 2013, the Company entered into a sublease agreement with NeXeption, Inc. ("NeXeption"), which was subsequently assigned to NST Consulting, LLC, a wholly-owned subsidiary of NST, LLC. In November 2017, the Company terminated the sublease with NST Consulting, LLC effective March 31, 2018. The Company agreed to pay $590 to NST Consulting, LLC, which amount represents accelerated rent payments. Total payments made under the sublease during the three months ended March 31, 2018 and 2017 were $570 and $75, respectively.

In February 2014, the Company entered into a services agreement with NST, LLC (the “NST Services Agreement”), pursuant to which NST, LLC provided certain pharmaceutical development, management and other administrative services to the Company. Under the same agreement, the Company also provided services to another company under common control with the Company and NST, LLC and was reimbursed by NST, LLC for those services. In November 2017, the Company terminated the NST Services Agreement effective December 31, 2017.

Mr. Stephen Tullman, the chairman of the Company’s board of directors, was an executive officer of NeXeption and is also the manager of NST Consulting, LLC and NST, LLC, and three of the Company’s executive officers are and have been members of entities affiliated with NST, LLC.

During the three months ended March 31, 2018 and 2017, amounts included in the condensed consolidated statement of operations and comprehensive loss for the NST Services Agreement are summarized in the following table:

	Three Months Ended March 31,	
	2018	2017
Services provided by NST Consulting, LLC	$ —	$ 56
Services provided to NST Consulting, LLC	—	(11)
General and administrative expense, net	$ —	$ 45
Net payments made to NST Consulting, LLC	$ —	$ 135

The Company had a net amount payable of $0 and $570 to NST Consulting, LLC under the NST Services Agreement as of March 31, 2018 and December 31, 2017, respectively.

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12. Agreements Related to Intellectual Property

Assignment Agreement and Finder's Services Agreement

In August 2012, the Company entered into an assignment agreement with the Estate of Mickey Miller, or the Miller Estate, under which the Company acquired some of the intellectual property rights covering A-101. In connection with obtaining the assignment of the intellectual property from the Miller Estate, the Company also entered into a separate finder's services agreement with KPT Consulting, LLC. In February 2016, under the terms of the assignment agreement and the finder's services agreement, the Company made a milestone payment of $300 upon the dosing of the first human subject with ESKATA in the Company's Phase 3 clinical trial. In April 2017, the Company made an additional milestone payment of $1,000 upon the achievement of specified regulatory milestones. The payments were recorded as general and administrative expenses in the Company's condensed consolidated statement of operations.

Under the finder's services agreement, the Company is obligated to make additional milestone payments of up to $4,500 upon the achievement of specified commercial milestones. Under each of the assignment agreement and the finder's services agreement, the Company is also obligated to pay royalties on sales of A-101 or related products, at low single-digit percentages of net sales, subject to reduction in specified circumstances. The Company has not made any royalty payments to date under either agreement. Both agreements will terminate upon the expiration of the last pending, viable patent claim of the patents acquired under the assignment agreement, but no sooner than 15 years from the effective date of the agreements.

13. Income Taxes

The Company did not record a federal or state income tax benefit for losses incurred during the three months ended March 31, 2018 and 2017 due to the Company's conclusion that a valuation allowance was required for those periods.

14. Segment Information

The Company has two reportable segments, dermatology therapeutics and contract research. The dermatology therapeutics segment is focused on identifying, developing and commercializing innovative and differentiated therapies to address significant unmet needs in medical and aesthetic dermatology. The Company's lead drug, ESKATA, is a proprietary formulation of high-concentration hydrogen peroxide topical solution that the Company is commercializing as an office-based prescription treatment for raised SKs, a common non-malignant skin tumor, and

which will be distributed by a wholesaler. The contract research segment earns revenue from the provision of laboratory services to clients through Confluence, the Company's wholly-owned subsidiary. Laboratory service revenue is generally evidenced by contracts with clients which are on an agreed upon fixed-price, fee-for-service basis. The Company does not report balance sheet information by segment since it is not reviewed by the chief operating decision maker, and all of the Company's tangible assets are held in the United States.

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The Company's results of operations by segment for the three months ended March 31, 2018 and 2017 are summarized in the tables below:

Three Months Ended March 31, 2018	Dermatology Therapeutics	Contract Research	Corporate and Other	Total Company
Revenue	$ —	$ 2,502	$ (1,384)	$ 1,118
Cost of revenue	—	2,120	(1,153)	967
Research and development	13,606	—	—	13,606
Sales and marketing	11,221	12	—	11,233
General and administrative	—	472	5,788	6,260
Loss from operations	$ (24,827)	$ (102)	$ (6,019)	$ (30,948)

Three Months Ended March 31, 2017	Dermatology Therapeutics	Contract Research	Corporate and Other	Total Company
Revenue	$ —	$ —	$ —	$ —
Cost of revenue	—	—	—	—
Research and development	7,772	—	—	7,772
Sales and marketing	1,438	—	—	1,438
General and administrative	93	—	3,627	3,720
Loss from operations	$ (9,303)	$ —	$ (3,627)	$ (12,930)

Foreign Subsidiary

The Company's wholly-owned subsidiary, ATIL, was formed and operates in the United Kingdom. ATIL is utilized for research and development, regulatory and administrative functions and had $142 and $175 of net assets, composed principally of cash, as of March 31, 2018 and December 31, 2017, respectively.

Intersegment Revenue

Revenue for the contract research segment includes $1,384 for services performed on behalf of the dermatology therapeutics segment for the three months ended March 31, 2018. The Company did not generate any revenue in the three months ended March 31, 2017. All intersegment revenue has been eliminated in the Company's condensed consolidated statement of operations.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Certain statements contained in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words or phrases "would be," "will allow," "intends to," "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project," or similar expressions, or the negative of such words or phrases, are intended to identify "forward-looking statements." We have based these forward-looking statements on our current expectations and projections about future events. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to these differences include those below and elsewhere in this Quarterly Report on Form 10-Q, particularly in Part II – Item 1A, "Risk Factors," in our Annual Report on Form 10-K in Part I, Item 1A, "Risk Factors," and in our other filings with the Securities and Exchange Commission, or SEC. Statements made herein are as of the date of the filing of this Form 10-Q with the SEC and should not be relied upon as of any subsequent date. Unless otherwise required by applicable law, we do not undertake, and we specifically disclaim, any obligation to update any forward-looking statements to reflect occurrences, developments, unanticipated events or circumstances after the date of such statement.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes that appear in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and related notes for the year ended December 31, 2017, which are included in our 2017 Annual Report on Form 10-K filed with the SEC, on March 12, 2018.

Overview

We are a dermatologist-led biopharmaceutical company focused on identifying, developing and commercializing innovative and differentiated therapies to address significant unmet needs in medical and aesthetic dermatology and immunology. Our lead product ESKATA (hydrogen peroxide) topical solution, 40% (w/w), or ESKATA, is a proprietary formulation of high-concentration hydrogen peroxide topical solution that has been approved by the U.S. Food and Drug Administration, or FDA, as an office-based prescription treatment for raised seborrheic keratosis, or SK, a common non-malignant skin tumor. The FDA approved our New Drug Application, or NDA, for ESKATA for the treatment of raised SKs in December 2017. We also submitted a Marketing Authorization Application, or MAA, for ESKATA in select countries in the European Union in July 2017. We are also developing another high-concentration formulation of hydrogen peroxide, A-101 45% Topical Solution, as a prescription treatment for common warts, also known as verruca vulgaris. Additionally, in 2015, we in-licensed exclusive, worldwide rights to certain inhibitors of the Janus kinase, or JAK, family of enzymes, for specified dermatological conditions, including alopecia areata, or AA, vitiligo and androgenetic alopecia, or AGA, also known as male or female pattern baldness. In 2016, we acquired additional intellectual property rights for the development and commercialization of certain JAK inhibitors for specified dermatological conditions. We intend to continue to in-license or acquire additional drug

candidates and technologies to build a fully integrated dermatology company.

We have been developing our sales, marketing and product distribution capabilities for ESKATA in order to support our commercial product launch in the United States. We have also hired a targeted sales force of 50 sales representatives which we believe will allow us to reach the approximately 6,000 health care providers in the United States with the highest potential for using ESKATA. In April 2018, we licensed the rights to commercialize A-101 40% Topical Solution in Canada for the treatment of raised SKs to Cipher Pharmaceuticals Inc., or Cipher. Under the terms of the license agreement, we will receive an upfront payment of $1.0 million, additional milestone payments upon the achievement of specified regulatory and commercial milestones, and royalties from the sale of A-101 40% Topical Solution in Canada. Cipher is responsible for all expenses related to regulatory and commercial activities for A-101 40% Topical Solution in Canada.

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We are developing A-101 45% Topical Solution for the treatment of common warts. In June 2017, we commenced two Phase 2 clinical trials, WART-202 and WART-203, of A-101 45% topical solution to assess the dose frequency in adult and pediatric patients with common warts. Both trials evaluated the safety and efficacy of A-101 45% Topical Solution as compared to placebo, or vehicle. The two randomized, double-blind, vehicle-controlled trials were designed to evaluate the effects of dose frequency and to explore additional clinical endpoints that will be further evaluated in a planned Phase 3 development program. We enrolled a total of 316 patients at 34 investigational centers in the United States across both trials. In January 2018, we reported top line results from these two Phase 2 clinical trials of A-101 45% Topical Solution. In March 2018, we reported final results, which included a 3-month drug-free follow-up phase, from the WART-203 clinical trial. In addition, in April 2018, we concluded the WART-202 clinical trial, in which we evaluated a different dosing regimen from the one used in the WART-203 clinical trial. In both of these clinical trials, patients treated with A-101 45% Topical Solution achieved clinically and statistically significant outcomes for the primary, secondary and exploratory endpoints of the trial. Based on the results from these clinical trials, we plan to propose a twice-weekly dosing regimen to the FDA for our planned Phase 3 clinical trials of A-101 45% Topical Solution for the treatment of common warts, which we expect to initiate in the second half of 2018. We expect to report data from these Phase 3 clinical trials in the second half of 2019 and, if those results are positive, to submit an NDA to the FDA thereafter.

We are developing our JAK inhibitor drug candidate ATI-501, which we in-licensed from Rigel Pharmaceuticals, Inc., or Rigel, as an oral treatment for AA. AA is an autoimmune dermatologic condition typically characterized by patchy non-scarring hair loss on the scalp and body. More severe forms of AA include total scalp hair loss, known as alopecia totalis, or AT, and total hair loss on the scalp and body, known as alopecia universalis, or AU. We submitted an investigational new drug application, or IND, to the FDA for ATI-501 for the treatment of AA in October 2016. Since the filing of the IND, we have conducted several Phase 1 clinical trials to evaluate the pharmacokinetic and pharmacodynamic, or PK/PD, properties of various formulations of ATI-501. We are evaluating the results of these clinical trials to finalize the design of our planned Phase 2 dose-response clinical trial of ATI-501 which we expect to initiate in the first half of 2018.

We are developing ATI-502, which we also in-licensed from Rigel, as a topical treatment for AA, vitiligo and AGA. We submitted an IND to the FDA for ATI-502 for the treatment of AA in July 2017. We are also developing another series of JAK inhibitors for the treatment of AGA. The following table summarizes the status of our ongoing Phase 2 clinical trials of ATI-501 and ATI-502, including their indications, trial objectives and expected timing for initiation and receipt of preliminary results:

Study	Indication	Objective	Patients	Expected Initiation	P Preliminary Results Expected
ATI-501					
AUAT-201	AT/AU	Dose-ranging	120-160	1H 2018	Mid 2019
ATI-502					

AA-201	AA	Dose-ranging	120	Initiated	2H 2018
AA-202	AA	PK/PD	12	Initiated	1H 2018
AUATB-201	AA (Eyebrow)	Open-label study	24	Initiated	Mid 2018
VITI-201	Vitiligo	Open-label study	24	Initiated	1H 2019
AGA-201	AGA	Open-label study	24	1H 2018	1H 2019

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In August 2017, we acquired Aclaris Life Sciences Inc. (formerly known as Confluence Life Sciences, Inc.), or Confluence. The acquisition of Confluence added small molecule drug discovery and preclinical development capabilities that allow us to bring early-stage research and development activities in-house that we previously outsourced to third parties. Through the acquisition of Confluence, we also acquired several preclinical drug candidates, including additional JAK inhibitors known as "soft" JAK inhibitors, inhibitors of the MK-2 signaling pathway and inhibitors of interleukin-2-inducible T cell kinase, or ITK. We expect to submit an IND to the FDA for ATI-450, an MK-2 inhibitor, in mid-2019, and for our soft JAK inhibitors and ITK inhibitors in the second half of 2019. We plan to develop ATI-450 for the treatment of psoriasis, psoriatic arthritis, rheumatoid arthritis, cryopyrin-associated periodic syndrome, pyoderma gangrenosum and inflammatory bowel disease. We plan to develop our ITK inhibitors for the treatment of atopic dermatitis and psoriasis.

Since our inception in July 2012, we have devoted substantially all of our resources to organizing and staffing our company, business planning, raising capital, developing ESKATA for the treatment of raised SKs, building our intellectual property portfolio, developing our supply chain and engaging in other discovery and clinical activities in dermatology. We have financed our operations with sales of our convertible preferred stock, as well as net proceeds from our initial public offering, or IPO, in October 2015, a private placement of our common stock in June 2016, public offerings of our common stock in November 2016 and August 2017, and an at-the-market facility with Cowen and Company LLC, or Cowen, that we entered into in November 2016.

Since our inception, we have incurred significant operating losses. Our net loss was $30.2 million for the three months ended March 31, 2018 and $68.5 million for the year ended December 31, 2017. As of March 31, 2018, we had an accumulated deficit of $189.7 million. We expect to incur significant expenses and operating losses related to product manufacturing, marketing, sales and distribution over the next several years as we begin to commercialize ESKATA. In addition, ESKATA and our drug candidates, if approved, may not achieve commercial success. Though we have commercially launched ESKATA, we do not expect to generate substantial revenue from sales of ESKATA in the near term, if at all. We also expect to incur significant expenses and operating losses for the foreseeable future as we advance our drug candidates from discovery through preclinical development and clinical trials. In addition, if we obtain marketing approval for any of our drug candidates, we expect to incur significant commercialization expenses related to product manufacturing, marketing, sales and distribution. We may also incur expenses in connection with the in-license or acquisition of additional drug candidates. Furthermore, we have incurred and expect to continue to incur significant costs associated with operating as a public company, including legal, accounting, investor relations and other expenses. As a result, we will need substantial additional funding to support our continuing operations and pursue our growth strategy. Until such time as we can generate significant revenue from product sales, if ever, we expect to finance our operations through the sale of equity, debt financings or other capital sources, including potential collaborations with other companies or other strategic transactions. We may be unable to raise additional funds or enter into such other agreements or arrangements when needed on commercially acceptable terms, or at all. If we fail to raise capital or enter into such agreements as, and when, needed, we may have to significantly delay, scale back or discontinue the development and commercialization of one or more of our drug candidates or delay our pursuit of potential in-licenses or acquisitions.

Components of Our Results of Operations

Revenue

We account for revenue in accordance with Accounting Standards Codification, or ASC, Topic 606, Revenue from Contracts with Customers. Under Topic 606, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration to which we expect to be entitled in exchange for those goods or services.

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To determine revenue recognition in accordance with ASC Topic 606, we perform the following five steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) performance obligations are satisfied. We recognize revenue when collection of the consideration it is entitled to under a contract with a customer is probable. At contract inception, we assess the goods or services promised within a contract with a customer to identify the performance obligations, and to determine if they are distinct. We recognize revenue that is allocated to each distinct performance obligation when (or as) that performance obligation is satisfied.

We earn revenue from the provision of laboratory services to clients through Confluence, our wholly-owned subsidiary. Laboratory service revenue is generally evidenced by contracts with clients which are on an agreed upon fixed-price, fee-for-service basis and are generally billed on a monthly basis in arrears for services rendered. Revenue related to these contracts is generally recognized as the laboratory services are performed, based upon the rates specified in the contracts. Under ASC Topic 606, we elected to apply the “right to invoice” practical expedient when recognizing laboratory service revenue. We recognize laboratory service revenue in the amount to which we have the right to invoice.

We also receive revenue from grants under the Small Business Innovation Research program of the National Institutes of Health, or NIH. Through our Confluence subsidiary, we currently have two active grants from NIH which are related to early-stage research. We recognize revenue related to these grants as amounts become reimbursable under each grant, which is generally when research is performed and the related costs are incurred.

Cost of Revenue

Cost of revenue consists of costs incurred in connection with the provision of laboratory services to our clients through Confluence. Cost of revenue primarily includes:

- employee-related expenses, which include salaries, benefits and stock-based compensation;
- outsourced professional scientific services;
- depreciation of laboratory equipment;
- facility-related costs; and
- laboratory materials and supplies used to support the services provided.

Research and Development Expenses

Research and development expenses consist of expenses incurred in connection with the discovery and development of our drug candidates. These expenses primarily include:

- expenses incurred under agreements with contract research organizations, or CROs, as well as investigative sites and consultants that conduct our clinical trials and preclinical studies;
- manufacturing scale-up expenses and the cost of acquiring and manufacturing preclinical and clinical trial materials and commercial materials, including manufacturing validation batches;
- outsourced professional scientific development services;
- medical affairs related expenses;
- employee-related expenses, which include salaries, benefits and stock-based compensation;
- depreciation of manufacturing equipment;
- payments made under agreements with third parties under which we have acquired or licensed intellectual property;
- expenses relating to regulatory activities, including filing fees paid to regulatory agencies; and
- laboratory materials and supplies used to support our research activities.

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Research and development activities are central to our business model. Drug candidates in later stages of clinical development generally have higher development costs than those in earlier stages of clinical development, primarily due to the increased size and duration of later-stage clinical trials. We expect our research and development expenses to increase significantly over the next several years as we increase personnel costs, including stock-based compensation, continue to conduct clinical trials of A-101 45% Topical Solution for the treatment of common warts, and conduct clinical trials and prepare regulatory filings for our other drug candidates. We expense research and development costs as incurred. Our direct research and development expenses primarily consist of external costs including fees paid to CROs, consultants, investigator sites, regulatory agencies and third parties that manufacture our preclinical and clinical trial materials, and are tracked on a program-by-program basis. We do not allocate personnel costs, facilities or other indirect expenses, to specific research and development programs.

The successful development of our drug candidates is highly uncertain. At this time, we cannot reasonably estimate or know the nature, timing and costs of the efforts that will be necessary to complete the remainder of the development of, or when, if ever, material net cash inflows may commence from any of our drug candidates. This uncertainty is due to the numerous risks and uncertainties associated with the duration and cost of clinical trials, which vary significantly over the life of a project as a result of many factors, including:

- the number of clinical sites included in the trials;
- the length of time required to enroll suitable patients;
- the number of patients that ultimately participate in the trials;
- the number of doses patients receive;
- the duration of patient follow-up; and
- the results of our clinical trials.

Our expenditures are subject to additional uncertainties, including the terms and timing of marketing approvals, and the expense of filing, prosecuting, defending and enforcing any patent claims or other intellectual property rights. We may never succeed in achieving marketing approval for any of our drug candidates. We may obtain unexpected results from our clinical trials. We may elect to discontinue, delay or modify clinical trials of some drug candidates or focus on others. A change in the outcome of any of these variables with respect to the development of a drug candidate could mean a significant change in the costs and timing associated with the development of that drug candidate. For example, if the FDA or other regulatory authorities were to require us to conduct clinical trials beyond those that we currently anticipate, or if we experience significant delays in enrollment in any of our clinical trials, we could be required to expend significant additional financial resources and time on the completion of clinical development.

Sales and Marketing Expenses

Sales and marketing expenses include salaries and related costs for our sales force, as well as personnel in our marketing and sales operations functions, including stock-based compensation, travel expenses and recruiting expenses. Sales and marketing expenses also include costs of content development, advertising, sponsorships and attendance at dermatology conferences as well as costs related to developing our direct-to-consumer advertising

campaign, which we expect to launch in the fourth quarter of 2018.

Additionally, we anticipate significant increases in our sales and marketing expenses as a result of the launch of commercial product sales of ESKATA in May 2018.

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General and Administrative Expenses

General and administrative expenses consist principally of salaries and related costs for personnel in executive, administrative, finance and legal functions, including stock-based compensation, travel expenses and recruiting expenses. General and administrative expenses also include facility-related costs, patent filing and prosecution costs, professional fees for legal, auditing and tax services, insurance costs, as well as payments made under our related party services agreement and milestone payments under our finder's services agreement. We anticipate that our general and administrative expenses will increase as a result of increased personnel costs, including stock-based compensation, expanded infrastructure and higher consulting, legal and tax-related services associated with maintaining compliance with Nasdaq and SEC requirements, accounting and investor relations costs, and director and officer insurance premiums associated with being a public company.

Other Income, Net

Other income, net consists of interest earned on our cash, cash equivalents and marketable securities, interest expense, and gains and losses on transactions denominated in foreign currencies.

Critical Accounting Policies and Significant Judgments and Estimates

This discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our condensed consolidated financial statements. On an ongoing basis, we evaluate our estimates and judgments, including those related to accrued expenses, contingent consideration and stock-based compensation. We base our estimates on historical experience, known trends and events and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe there have been no material changes to our critical accounting policies and use of estimates as disclosed in the footnotes to our audited consolidated financial statements for the year ended December 31, 2017 included in our 2017 Annual Report on Form 10-K filed with the SEC on March 12, 2018.

Goodwill

Goodwill is not amortized, but rather is subject to testing for impairment at least annually, which we perform during the fourth quarter, or when indicators of an impairment are present. We consider each of our operating segments, dermatology therapeutics and contract research, to be a reporting unit since this is the lowest level for which discrete financial information is available. We have attributed the full amount of the goodwill acquired with Confluence, or $18,504, to the dermatology therapeutics segment. The annual impairment test performed by us is a qualitative assessment based upon current facts and circumstances related to operations of the dermatology therapeutics segment. If the qualitative assessment indicates an impairment may be present, we would perform the required quantitative analysis and an impairment charge would be recognized to the extent that the estimated fair value of the reporting unit is less than its carrying amount. However, any loss recognized would not exceed the total amount of goodwill allocated to that reporting unit.

Intangible Assets

Intangible assets include both finite lived and indefinite lived assets. Finite lived intangible assets are amortized over their estimated useful life based on the pattern over which the intangible assets are consumed or otherwise used up. If that pattern cannot be reliably determined, the straight-line method of amortization is used. Indefinite lived intangible assets are not amortized. In-process research and development assets acquired in a business combination are considered

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indefinite lived until the completion or abandonment of the associated research and development efforts. We test intangible assets for impairment at least annually, or if indicators of impairment are present. We recognize impairment losses when and to the extent that the estimated fair value of an intangible asset is less than its carrying value.

Contingent Consideration

We initially recorded the contingent consideration related to future potential payments based upon the achievement of certain development, regulatory and commercial milestones, resulting from the acquisition of Confluence, at its estimated fair value on the date of acquisition. Changes in fair value reflect new information about the likelihood of the payment of the contingent consideration and the passage of time. For example, if the timing of the development of an acquired drug candidate, or the size of potential commercial opportunities related to an acquired drug, differ from our assumptions, then the fair value of contingent consideration would be adjusted accordingly. Future changes in the fair value of the contingent consideration, if any, will be recorded as income or expense in our consolidated statement of operations.

Recently Issued Accounting Pronouncements

In January 2017, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, 2017-01, Business Combinations-Clarifying the Definition of a Business (Topic 805). The amendments in this ASU provide a screen to determine when a set of acquired assets and/or activities is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired, or disposed of, is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. The amendments in this ASU will reduce the number of transactions that meet the definition of a business. ASU 2017-01 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within those years, and early adoption will be permitted. We adopted this standard as of January 1, 2018, the impact of which on our consolidated financial statements was not significant.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). Under this ASU, entities should recognize revenue in an amount that reflects the consideration to which they expect to be entitled to in exchange for goods and services provided. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017. We adopted the provisions of this standard on January 1, 2018, using the modified retrospective transition method. We did not recognize any transition adjustments as a result of adopting ASU 2014-09 and, accordingly, comparative information has not been restated for the periods reported.

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Results of Operations

Comparison of Three Months Ended March 31, 2018 and 2017

	Three Months Ended March 31,		
	2018	2017	Change
	(In thousands)		
Revenue	$ 1,118	$ —	$ 1,118
Cost of revenue	967	—	967
Gross profit	151	—	151
Operating expenses:			
Research and development	13,606	7,772	5,834
Sales and marketing	11,233	1,438	9,795
General and administrative	6,260	3,720	2,540
Total operating expenses	31,099	12,930	18,169
Loss from operations	(30,948)	(12,930)	(18,018)
Other income, net	719	371	348
Net loss	$ (30,229)	0.2	
Issuance of Class A common stock, net of stock received for minimum tax withholdings[2]	0.2	1.5	0.7
Purchases of Class A common stock	(4.7)	—	—
Balance at end of fiscal year	140.0	144.0	141.8
Class A Common Stock:			
Balance at beginning of fiscal year	$ 0.7	$ 0.7	$ 0.4
Issuance of Class A common stock, net of stock received for minimum tax withholdings	—	—	0.3
Two-for-one stock split [1]	0.7	—	—
Balance at end of fiscal year	1.4	0.7	0.7
Capital in Excess of Par Value:			
Balance at beginning of fiscal year	2,871.4	2,810.8	2,762.7
Income tax benefit from share-based plans	15.0	5.7	8.4
Compensation expense under share-based plans	42.6	46.5	29.2
Issuance of Class A common stock, net of stock received for minimum tax withholdings	4.7	8.4	10.5
Purchases of Class A common stock	(93.2)	—	—
Two-for-one stock split [1]	(0.7)	—	—
Balance at end of fiscal year	2,839.8	2,871.4	2,810.8
Retained Earnings:			
Balance at beginning of fiscal year	1,740.8	1,094.7	907.4
Net income attributable to Rock-Tenn Company shareholders	479.7	727.3	249.1
Cash dividends (per share - $0.70, $0.525 and $0.40) [3]	(100.8)	(76.3)	(56.5)
	(15.7)	(4.9)	(5.3)

Issuance of Class A common stock, net of stock received for minimum tax withholdings			
Purchases of Class A common stock	(143.1)	—	—
Balance at end of fiscal year	1,960.9	1,740.8	1,094.7
Accumulated Other Comprehensive Loss:			
Balance at beginning of fiscal year	(300.6)	(500.5)	(299.2)
Other comprehensive (loss) income, net of tax	(194.7)	199.9	(201.3)
Balance at end of fiscal year	(495.3)	(300.6)	(500.5)
Total Rock-Tenn Company Shareholders' equity	4,306.8	4,312.3	3,405.7
Noncontrolling Interests:[4]			
Balance at beginning of fiscal year	0.5	0.5	0.7
Net income (loss)	0.5	0.4	(0.1)
Distributions	(0.4)	(0.4)	(0.1)
Balance at end of fiscal year	0.6	0.5	0.5
Total equity	$ 4,307.4	$ 4,312.8	$ 3,406.2

(1) On August 27, 2014, we effected a two-for-one stock split of our Common Stock in the form of a 100% stock dividend to shareholders of record as of August 12, 2014. All share and per share information has been retroactively adjusted to reflect the stock split and we recorded the incremental par value of the newly issued shares with the offset to additional paid in capital.

(2) In connection with the Smurfit-Stone Acquisition, there were approximately 1.4 million shares reserved but unissued at the time of the acquisition for the resolution of Smurfit-Stone bankruptcy claims. In fiscal 2013, 1.1 million shares previously reserved but unissued were issued related to the Smurfit-Stone bankruptcy claims. At September 30, 2014, 0.3 million shares remain reserved and unissued.

(3) Includes cash dividends paid and dividends declared but unpaid related to the shares reserved but unissued at the time of the acquisition for the resolution of Smurfit-Stone bankruptcy claims.

(4) Excludes amounts related to contingently redeemable noncontrolling interests which are separately classified outside of permanent equity in the Consolidated Balance Sheets.

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ROCK-TENN COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended September 30,		
	2014	2013	2012
	(In millions)		
Operating activities:			
Consolidated net income	$483.8	$732.5	$252.2
Adjustments to reconcile consolidated net income to net cash provided by operating activities:			
Depreciation and amortization	584.5	552.2	534.3
Deferred income tax expense (benefit)	252.1	(44.3)	123.4
Share-based compensation expense	42.6	46.5	29.2
Loss on extinguishment of debt	—	0.3	25.9
Loss (gain) on disposal of plant, equipment and other, net	0.3	(13.9)	(10.0)
Equity in income of unconsolidated entities	(8.8)	(4.6)	(3.4)
Pension and other postretirement funding more than expense	(175.0)	(167.1)	(305.4)
Settlement of interest rate swaps	—	—	(2.8)
Impairment adjustments and other non-cash items	5.5	21.2	29.2
Change in operating assets and liabilities, net of acquisitions:			
Accounts receivable	67.3	(63.2)	55.5
Inventories	(80.5)	(122.8)	7.1
Other assets	(1.9)	(13.1)	(17.8)
Accounts payable	(11.6)	87.5	(77.8)
Income taxes	1.9	(13.8)	13.3
Accrued liabilities and other	(8.4)	35.1	3.8
Net cash provided by operating activities	1,151.8	1,032.5	656.7
Investing activities:			
Capital expenditures	(534.2)	(440.4)	(452.4)
Cash paid for the purchase of a leased facility	—	—	(17.0)
Cash paid for purchase of businesses, net of cash acquired	(474.4)	(6.3)	(125.6)
Investment in unconsolidated entities	—	(0.1)	(1.7)
Return of capital from unconsolidated entities	7.0	1.0	1.8
Proceeds from sale of subsidiary and affiliates	6.8	—	—
Proceeds from sale of property, plant and equipment	22.4	26.8	40.5
Proceeds from property, plant and equipment insurance settlement	5.0	15.4	10.2
Net cash used for investing activities	(967.4)	(403.6)	(544.2)
Financing activities:			
Proceeds from issuance of notes	—	—	1,442.2
Additions to revolving credit facilities	233.8	99.0	748.1
Repayments of revolving credit facilities	(285.9)	(146.2)	(759.8)
Additions to debt	663.8	277.0	326.6
Repayments of debt	(465.1)	(787.4)	(1,803.6)
Commercial card program	3.8	—	—
Debt issuance costs	(0.7)	(2.0)	(16.2)
Cash paid for debt extinguishment costs	—	(0.1)	(14.0)
Issuances of common stock, net of related minimum tax withholdings	(11.0)	3.5	5.2
Purchases of common stock	(236.3)	—	—

Excess tax benefits from share-based compensation	15.1	6.0	10.0
Repayments to (advances from) unconsolidated entity	(2.0)	1.2	0.2
Cash dividends paid to shareholders	(101.1)	(75.3)	(56.5)
Cash distributions paid to noncontrolling interests	(2.5)	(4.9)	(0.8)
Net cash used for financing activities	(188.1)	(629.2)	(118.6)
Effect of exchange rate changes on cash and cash equivalents	(0.1)	(0.5)	1.6
Decrease in cash and cash equivalents	(3.8)	(0.8)	(4.5)
Cash and cash equivalents at beginning of fiscal year	36.4	37.2	41.7
Cash and cash equivalents at end of fiscal year	$32.6	$36.4	$37.2

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Supplemental disclosure of cash flow information:

	Year Ended September 30,		
	2014	2013	2012
	(In millions)		
Cash paid (received) during the period for:			
Income taxes, net of refunds	$18.8	$22.0	$(9.6)
Interest, net of amounts capitalized	86.9	98.8	114.8

Supplemental schedule of non-cash investing activities:

Liabilities assumed in fiscal 2014 relate to the Tacoma Mill, NPG and AGI In-Store acquisitions. Liabilities assumed in fiscal 2013 relate to the acquisition of a corrugated sheet plant, and in fiscal 2012 they relate to the acquisition of GMI, Mid South and adjustments to the fiscal 2011 Smurfit-Stone preliminary purchase price allocation. For additional information regarding these acquisitions see “Note 5. Acquisitions”.

	Year Ended September 30,		
	2014	2013	2012
	(In millions)		
Fair value of assets acquired, including goodwill	$525.3	$7.9	$145.7
Cash consideration, net of cash acquired	472.2	6.3	122.3
Liabilities assumed	$53.1	$1.6	$23.4

See Accompanying Notes

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ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Description of Business and Summary of Significant Accounting Policies

Description of Business

We are one of North America's leading providers of packaging solutions and manufacturers of containerboard and paperboard. We operate locations in the U.S., Canada, Mexico, Chile, Argentina and Puerto Rico.

Consolidation

The consolidated financial statements include our accounts and the accounts of our partially-owned consolidated subsidiaries. Equity investments in which we exercise significant influence but do not control and are not the primary beneficiary are accounted for using the equity method. Investments in which we are not able to exercise significant influence over the investee are accounted for under the cost method. Our equity and cost method investments are not significant either individually or in the aggregate. We have eliminated all significant intercompany accounts and transactions. Unless the context otherwise requires, “we”, “us”, “our”, “RockTenn” and “the Company” refer to the business of Rock-Tenn Company, its wholly-owned subsidiaries and its partially-owned consolidated subsidiaries.

Use of Estimates

Preparing consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates, and the differences could be material.

The most significant accounting estimates inherent in the preparation of our consolidated financial statements include estimates to evaluate the recoverability of goodwill, intangibles and property, plant and equipment, to determine the useful lives of assets that are amortized or depreciated, and to measure income taxes, self-insured obligations, restructuring activities and allocate the purchase price of an acquired business to the fair value of acquired assets and liabilities. In addition, significant estimates form the basis for our reserves with respect to collectibility of accounts receivable, inventory valuations, pension benefits, deferred tax asset valuation allowances and certain benefits provided to current employees. Various assumptions and other factors underlie the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account factors such as historical experience, current and expected economic conditions, product mix, and in some cases, actuarial techniques. We regularly evaluate these significant factors and make adjustments where facts and circumstances dictate.

Common Stock Split

On August 27, 2014, we effected a two-for-one stock split of our Common Stock in the form of a 100% stock dividend to shareholders of record as of August 12, 2014. All share and per share information has been retroactively adjusted to reflect the stock split and we recorded the incremental par value of the newly issued shares with the offset to additional paid in capital.

Revenue Recognition

We recognize revenue when there is persuasive evidence that an arrangement exists, delivery has occurred or services have been rendered, our price to the buyer is fixed or determinable and collectibility is reasonably assured. Delivery is not considered to have occurred until the customer takes title and assumes the risks and rewards of ownership. The timing of revenue recognition is dependent on the location of title transfer which is normally either on the exit from our plants (i.e., shipping point) or on arrival at customers' plants (i.e., destination point). We do not recognize revenue from transactions where we bill customers but retain custody and title to these products until the date custody and title transfer. We do not have any significant multiple deliverable revenue arrangements.

We net, against our gross sales, provisions for discounts, returns, allowances, customer rebates and other adjustments. We account for such provisions during the same period in which we record the related revenues. We include in net sales any amounts related to shipping and handling that are billed to a customer.

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Shipping and Handling Costs

We classify shipping and handling costs as a component of cost of goods sold.

Cash Equivalents

We consider all highly liquid investments that mature three months or less from the date of purchase to be cash equivalents. The carrying amounts we report in the consolidated balance sheets for cash and cash equivalents approximate fair market values. We place our cash and cash equivalents with large credit worthy banks, which limits the amount of our credit exposure.

Accounts Receivable and Allowances

We perform periodic evaluations of our customers' financial condition and generally do not require collateral. Receivables generally are due within 30 to 60 days, although recent trends are for customers to seek longer terms. We serve a diverse customer base primarily in North America and, therefore, have limited exposure from credit loss to any particular customer or industry segment.

We state accounts receivable at the amount owed by the customer, net of an allowance for estimated uncollectible accounts, returns and allowances, cash discounts and other adjustments. We do not discount accounts receivable because we generally collect accounts receivable over a relatively short time. We account for sales and other taxes that are imposed on and concurrent with individual revenue-producing transactions between a customer and us on a net basis which excludes the taxes from our net sales. We estimate our allowance for doubtful accounts based on our historical experience, current economic conditions and the credit worthiness of our customers. We charge off receivables when they are determined to be no longer collectible. In fiscal 2014, 2013 and 2012, we recorded bad debt expense of $2.0 million, $5.6 million and $6.6 million, respectively.

The following table represents a summary of the changes in the reserve for allowance for doubtful accounts, returns and allowances and cash discounts for fiscal 2014, 2013 and 2012 (in millions):

	2014	2013	2012
Balance at beginning of fiscal year	$26.8	$26.9	$30.1
Reduction in sales and charges to costs and expenses [1]	135.0	126.4	107.9
Deductions	(136.7)	(126.5)	(111.1)
Balance at end of fiscal year	$25.1	$26.8	$26.9

[1] Includes the impact of acquisitions.

Inventories

We value substantially all U.S. inventories at the lower of cost or market, with cost determined on the LIFO basis. We value all other inventories at the lower of cost or market, with cost determined using methods that approximate cost computed on a FIFO basis. These other inventories represent primarily foreign inventories, spare parts inventories and certain inventoried supplies and aggregate to approximately 26% and 24% of FIFO cost of all inventory at September 30, 2014 and 2013, respectively.

Prior to the application of the LIFO method, our U.S. operating divisions use a variety of methods to estimate the FIFO cost of their finished goods inventories. Such methods include standard costs, or average costs computed by

dividing the actual cost of goods manufactured by the tons produced and multiplying this amount by the tons of inventory on hand. Lastly, certain operations calculate a ratio, on a plant by plant basis, the numerator of which is the cost of goods sold and the denominator is net sales. This ratio is applied to the estimated sales value of the finished goods inventory. Variances and other unusual items are analyzed to determine whether it is appropriate to include those items in the value of inventory. Examples of variances and unusual items that are considered to be current period charges include, but are not limited to, abnormal production levels, freight, handling costs, and wasted materials (spoilage). Cost includes raw materials and supplies, direct labor, indirect labor related to the manufacturing process and depreciation and other factory overheads.

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Property, Plant and Equipment

We state property, plant and equipment at cost. Cost includes major expenditures for improvements and replacements that extend useful lives, increase capacity, increase revenues or reduce costs. During fiscal 2014, 2013 and 2012, we capitalized interest of approximately $2.6 million, $2.9 million and $3.4 million, respectively. For financial reporting purposes, we provide depreciation and amortization primarily on a straight-line method generally over the estimated useful lives of the assets as follows:

Buildings and building improvements	15-40 years
Machinery and equipment	3-25 years
Transportation equipment	3-8 years

Generally our machinery and equipment have estimated useful lives between 3 and 25 years; however, select portions of machinery and equipment primarily at our mills have estimated useful lives up to 44 years. Greater than 90% of the cost of our mill assets have lives of 25 years or less. Leasehold improvements are depreciated over the shorter of the asset life or the lease term, generally between 3 and 10 years. Depreciation expense for fiscal 2014, 2013 and 2012 was approximately $481.7 million, $461.3 million and $434.6 million, respectively.

Goodwill and Long-Lived Assets

We review the carrying value of our goodwill annually at the beginning of the fourth quarter of each fiscal year, or more often if events or changes in circumstances indicate that the carrying amount may exceed fair value as set forth in ASC 350, “Intangibles — Goodwill and Other”. We test goodwill for impairment at the reporting unit level, which is an operating segment or one level below an operating segment, which is referred to as a component. A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. However, two or more components of an operating segment are aggregated and deemed a single reporting unit if the components have similar economic characteristics. The amount of goodwill acquired in a business combination that is assigned to one or more reporting units as of the acquisition date is the excess of the purchase price of the acquired businesses (or portion thereof) included in the reporting unit, over the fair value assigned to the individual assets acquired or liabilities assumed. Goodwill is assigned to the reporting unit(s) expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. We determine recoverability by comparing the estimated fair value of the reporting unit to which the goodwill applies to the carrying value, including goodwill, of that reporting unit using a discounted cash flow model.

The goodwill impairment model is a two-step process. An amendment to ASC 350 became effective December 2011 that allows a qualitative assessment, prior to step one, to determine whether it is more likely than not that the fair value of a reporting unit exceeds its carrying amount. We did not attempt a qualitative assessment and moved directly to step one. In step one, we utilize the present value of expected net cash flows to determine the estimated fair value of our reporting units. This present value model requires management to estimate future net cash flows, the timing of these cash flows, and a discount rate (based on a weighted average cost of capital), which represents the time value of money and the inherent risk and uncertainty of the future cash flows. Factors that management must estimate when performing this step in the process include, among other items, sales volume, prices, inflation, discount rates, exchange rates, tax rates, anticipated synergies and productivity improvements resulting from acquisitions, capital expenditures and continuous improvement projects. The assumptions we use to estimate future cash flows are consistent with the assumptions that the reporting units use for internal planning purposes, updated to reflect current

expectations. If we determine that the estimated fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not impaired. If we determine that the carrying amount of the reporting unit exceeds its estimated fair value, we would complete step two of the impairment analysis. Step two involves determining the implied fair value of the reporting unit's goodwill and comparing it to the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, we recognize an impairment loss in an amount equal to that excess. We completed the annual test of the goodwill associated with each of our reporting units during fiscal 2014 and concluded the fair values were in excess of the carrying values of each of the reporting units. No events have occurred since the latest annual goodwill impairment assessment that would necessitate an interim goodwill impairment assessment.

We follow provisions included in ASC 360, "Property, Plant and Equipment" in determining whether the carrying value of any of our long-lived assets, including amortizing intangibles other than goodwill, is impaired. The ASC 360 test is a three-step

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

test for assets that are “held and used” as that term is defined by ASC 360. We determine whether indicators of impairment are present. We review long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount of the long-lived asset might not be recoverable. If we determine that indicators of impairment are present, we determine whether the estimated undiscounted cash flows for the potentially impaired assets are less than the carrying value. This requires management to estimate future net cash flows through operations over the remaining useful life of the asset and its ultimate disposition. The assumptions we use to estimate future cash flows are consistent with the assumptions we use for internal planning purposes, updated to reflect current expectations. If our estimated undiscounted cash flows do not exceed the carrying value, we estimate the fair value of the asset and record an impairment charge if the carrying value is greater than the fair value of the asset. We estimate fair value using discounted cash flows, observable prices for similar assets, or other valuation techniques. We record assets classified as “held for sale” at the lower of their carrying value or estimated fair value less anticipated costs to sell.

Included in our long-lived assets are certain identifiable intangible assets. These intangible assets are amortized based on the approximate pattern in which the economic benefits are consumed or straight-line if the pattern was not reliably determinable. Estimated useful lives range from 2 to 40 years and have a weighted average life of approximately 12.3 years.

Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance. Future events could cause us to conclude that impairment indicators exist and that assets associated with a particular operation are impaired. Evaluating impairment also requires us to estimate future operating results and cash flows, which also require judgment by management. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Restructuring

We have restructured portions of our operations from time to time, have current restructuring initiatives taking place, and it is possible that we may engage in future restructuring activities. Identifying and calculating the cost to exit these operations requires certain assumptions to be made, the most significant of which are anticipated future liabilities, including leases and other contractual obligations, and the adjustment of property, plant and equipment to net realizable value. We believe our estimates are reasonable, considering our knowledge of the industries we operate in, previous experience in exiting activities and valuations we may obtain from independent third parties. Although our estimates have been reasonably accurate in the past, significant judgment is required, and these estimates and assumptions may change as additional information becomes available and facts or circumstances change.

Business Combinations

From time to time, we enter into business combinations. In accordance with ASC 805, “Business Combinations”, we generally recognize the identifiable assets acquired, the liabilities assumed, and any noncontrolling interests in an acquiree at their fair values as of the date of acquisition. We measure goodwill as the excess of consideration transferred, which we also measure at fair value, over the net of the acquisition date fair values of the identifiable assets acquired and liabilities assumed. The acquisition method of accounting requires us to make significant estimates and assumptions regarding the fair values of the elements of a business combination as of the date of acquisition, including the fair values of identifiable intangible assets, deferred tax asset valuation allowances, liabilities related to uncertain tax positions, contingent consideration and contingencies. This method also requires us to refine these estimates over a measurement period not to exceed one year to reflect new information obtained about

facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. If we are required to retroactively adjust provisional amounts that we have recorded for the fair values of assets and liabilities in connection with acquisitions, these adjustments could have a material impact on our financial condition and results of operations.

Significant estimates and assumptions in estimating the fair value of acquired technology, customer relationships, and other identifiable intangible assets include future cash flows that we expect to generate from the acquired assets. If the subsequent actual results and updated projections of the underlying business activity change compared with the assumptions and projections used to develop these values, we could record impairment charges. In addition, we have estimated the economic lives of certain acquired assets and these lives are used to calculate depreciation and amortization expense. If our estimates of the economic lives change, depreciation or amortization expenses could be increased or decreased, or the acquired asset could be impaired.

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Fair Value of Financial Instruments and Nonfinancial Assets and Liabilities

We estimate fair values in accordance with ASC 820 “Fair Value Measurement”. We define fair value as the price that would be received from the sale of an asset or 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.

Financial instruments not recognized at fair value on a recurring or nonrecurring basis include cash and cash equivalents, accounts receivables, certain other current assets, short-term debt, accounts payable, certain other current liabilities and long-term debt. With the exception of long-term debt, the carrying amounts of these financial instruments approximate their fair values due to their short maturities. The fair values of our long-term debt are estimated using quoted market prices or are based on the discounted value of future cash flows. We disclose the fair value of long-term debt and our pension and postretirement assets and liabilities in “Note 9. Fair Value” and “Note 12. Retirement Plans” of the Notes to Consolidated Financial Statements. We have, or from time to time may have, financial instruments recognized at fair value including Supplemental Plans that are nonqualified deferred compensation plans pursuant to which assets are invested primarily in mutual funds, interest rate derivatives, commodity derivatives or other similar class of assets or liabilities, the fair value of which are not significant. We measure the fair value of our mutual fund investments based on quoted prices in active markets, and our derivative contracts, if any, and our prior year residual interest in TNH notes based on discounted cash flows.

We measure certain nonfinancial assets and nonfinancial liabilities at fair value on a nonrecurring basis. These assets and liabilities include cost and equity method investments when they are deemed to be other-than-temporarily impaired, assets acquired and liabilities assumed in an acquisition or in a nonmonetary exchange, and property, plant and equipment and goodwill and other intangible assets that are written down to fair value when they are held for sale or determined to be impaired. Given the nature of nonfinancial assets and liabilities, evaluating their fair value from the perspective of a market participant is inherently complex. Assumptions and estimates about future values can be affected by a variety of internal and external factors. Changes in these factors may require us to revise our estimates and could result in future impairment charges for goodwill and acquired intangible assets, or retroactively adjust provisional amounts that we have recorded for the fair values of assets and liabilities in connection with business combinations. These adjustments could have a material impact on our financial condition and results of operations. We discuss fair values in more detail in “Note 9. Fair Value.”

Health Insurance

We are self-insured for the majority of our group health insurance costs. We calculate our group health insurance reserve on an undiscounted basis based on estimated reserve rates. We utilize claims lag data provided by our claims administrators to compute the required estimated reserve rate. We calculate our average monthly claims paid using the actual monthly payments during the trailing 12-month period. At that time, we also calculate our required reserve using the reserve rates discussed above. While we believe that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our group health insurance costs.

Workers’ Compensation

We purchase large risk deductible workers’ compensation policies for the majority of our workers’ compensation liabilities that are subject to various deductibles to limit our exposure. We calculate our workers’ compensation reserves on an undiscounted basis based on estimated actuarially calculated development factors. While we believe

that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our workers' compensation costs.

Income Taxes

We account for income taxes under the asset and liability method, 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. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amount and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making such determination, we consider all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies, recent financial operations and their associated valuation allowances, if any. In the event we were to determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we would make an adjustment to the valuation allowance, which would reduce the provision for income taxes.

Certain provisions of ASC 740, “Income Taxes” provide that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Income tax positions must meet a more likely than not recognition threshold at the effective date to be recognized upon the adoption of these provisions and in subsequent periods. See “Note 11. Income Taxes.”

Pension and Other Postretirement Benefits

We account for pension and other postretirement benefits in accordance with ASC 715, “Compensation — Retirement Benefits”. Accordingly, we recognize the funded status of our pension plans as assets or liabilities in our consolidated balance sheets. The funded status is the difference between our projected benefit obligations and fair value of plan assets. The determination of our obligation and expense for pension and other postretirement benefits is dependent on our selection of certain assumptions used by actuaries in calculating such amounts. We describe these assumptions in “Note 12. Retirement Plans,” which include, among others, the discount rate, expected long-term rate of return on plan assets and rates of increase in compensation levels. As provided under ASC 715, we defer actual results that differ from our assumptions, i.e. actuarial gains and losses, and amortize the difference over future periods. Therefore, these differences generally affect our recognized expense and funding requirements in future periods. Actuarial gains and losses occur when actual experience differs from the estimates used to determine the components of net periodic pension cost and when certain assumptions used to determine the fair value of the plan assets or projected benefit obligation are updated, such as but not limited to, changes in the discount rate, plan amendments, differences between actual and expected returns on plan assets, mortality assumptions and plan remeasurement.

The amount of unrecognized actuarial gains and losses recognized in the current year’s operations is based on amortizing the unrecognized gains or losses for each plan that exceed the larger of 10% of the projected benefit obligation or the fair value of plan assets, also known as the corridor. The amount of unrecognized gain or loss that exceeds the corridor is amortized over the average future service of the plan participants or the average life expectancy of inactive plan participants for plans where all or almost all of the plan participants are inactive. While we believe that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our pension and other postretirement benefit obligations and our future expense.
Stock Based Compensation

We recognize expense for stock based compensation plans based on the estimated fair value of the related awards in accordance with ASC 718, “Compensation — Stock Compensation”. Pursuant to our 2004 Incentive Stock Plan, we can award shares of restricted Common Stock to employees and our board of directors. The grants generally vest over a period of three years depending on the nature of the award, except for non-employee director grants, which typically vest over one year. Our restricted stock grants to employees generally contain performance or market conditions that must be met in conjunction with a service requirement for the shares to vest. We charge compensation under the plan to earnings over each increment’s individual restriction period. See “Note 14. Share-Based Compensation” for additional information.

Asset Retirement Obligations

The Company accounts for asset retirement obligations in accordance with ASC 410, “Asset Retirement and Environmental Obligations”. A liability and an asset are recorded equal to the present value of the estimated costs associated with the retirement of long-lived assets where a legal or contractual obligation exists and the liability can be reasonably estimated. The liability is accreted over time and the asset is depreciated over the remaining life of the related asset. Upon settlement of the liability, we will recognize a gain or loss for any difference between the settlement amount and the liability recorded. Asset retirement obligations with indeterminate settlement dates are not recorded until such time that a reasonable estimate may be made. Our asset retirement obligations consist primarily of landfill closure and post-closure costs at certain of our paperboard mills. At September 30, 2014 and September 30, 2013, liabilities of $15.2 million and $14.9 million, respectively, were accrued.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Repair and Maintenance Costs

We expense routine repair and maintenance costs as we incur them. We defer expenses we incur during planned major maintenance activities and recognize the expenses ratably over the shorter of the estimated interval until the next major maintenance activity or the life of the deferred item. This maintenance is generally performed every twelve to twenty-four months and has a significant impact on our results of operations in the period performed primarily due to lost production during the maintenance period.

Foreign Currency

We translate the assets and liabilities of our foreign operations from their functional currency into U.S. dollars at the rate of exchange in effect as of the balance sheet date. We reflect the resulting translation adjustments in equity. We translate the revenues and expenses of our foreign operations at a daily average rate prevailing for each month during the fiscal year. We include gains or losses from foreign currency transactions, such as those resulting from the settlement of foreign receivables or payables, in the consolidated statements of income. We recorded a gain of $4.2 million in fiscal 2014, a gain of $2.5 million in fiscal 2013 and a loss of $5.5 million in 2012 from foreign currency transactions.

Environmental Remediation Costs

We accrue for losses associated with our environmental remediation obligations when it is probable that we have incurred a liability and the amount of the loss can be reasonably estimated. We generally recognize accruals for estimated losses from our environmental remediation obligations no later than completion of the remedial feasibility study and adjust such accruals as further information develops or circumstances change. We recognize recoveries of our environmental remediation costs from other parties as assets when we deem their receipt probable. See “Note 16. Commitments and Contingencies.”

New Accounting Standards - Recently Adopted

In March 2013, the FASB issued ASU 2013-05 “Foreign Currency Matters, Parents Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity”. This ASU amended ASC 810 “Consolidation”, ASC 805 “Business Combinations” and ASC 830 “Foreign Currency” and clarifies the criteria that should be considered, such as the loss or acquisition of a controlling financial interest and whether the sale or transfer results in the complete or substantially complete liquidation of an entity, to determine the release of cumulative translation adjustments into net income upon derecognition of a subsidiary, equity method investment or a group of assets within a foreign entity. These provisions were effective for annual and interim periods beginning after December 15, 2013 (January 1, 2014 for us). The adoption of these provisions did not have a material effect on our consolidated financial statements.
In July 2013, the FASB issued ASU 2013-11 “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists”. This ASU amends ASC 740 “Income Taxes” and clarifies when a liability related to an unrecognized tax benefit should be presented in the financial statements as a reduction to the related deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward. These provisions were effective for annual and interim periods beginning after December 15, 2013 (January 1, 2014 for us). The adoption of these provisions did not have a material effect on our consolidated financial statements.

New Accounting Standards - Recently Issued

In May 2014, the FASB issued ASU 2014-09 which is codified in ASC 606 “Revenue from Contracts with Customers” and supersedes both the revenue recognition requirement to ASC 605 “Revenue Recognition” and most industry-specific guidance. The core principle of ASC 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the five steps set forth in ASC 606. An entity must also disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative information about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. These provisions are effective for annual reporting periods beginning after December 15, 2016 (October 1, 2017 for us), including interim periods within that annual period, and can be applied using a full retrospective or modified retrospective approach. The Company is currently evaluating the impact of these provisions.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In June 2014, the FASB issued ASU 2014-12 “Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period”. This ASU amends ASC 718 “Compensation - Stock Compensation” and clarifies that a performance target in a share-based payment that affects vesting and that could be achieved after the requisite service period should be accounted for as a performance condition and impact compensation cost when it is probable the performance target will be achieved. These provisions are effective for annual periods beginning after December 15, 2015 (October 1, 2016 for us) and based on our current stock compensation awards are not expected to have a material effect on our consolidated financial statements.

In April 2014 the FASB issued ASU 2014-08 “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity”. This ASU amends ASC 360 “Property Plant and Equipment” and expands the disclosures for discontinued operations, and requires new disclosures for disposals of individually significant components that do not meet the new definition of a discontinued operation and are classified as assets held for sale. These provisions are effective for annual and interim periods beginning after December 15, 2014 (January 1, 2015 for us). We do not expect that the adoption of these provisions will have a material effect on our consolidated financial statements.

Note 2. Earnings per Share

Certain of our restricted stock awards are considered participating securities as they receive non-forfeitable rights to dividends at the same rate as common stock. As participating securities, we include these instruments in the earnings allocation in computing earnings per share under the two-class method described in ASC 260 “Earnings per Share.” The following table sets forth the computation of basic and diluted earnings per share under the two-class method (in millions, except per share data):

	September 30, 2014	2013	2012
Basic earnings per share:			
Numerator:			
Net income attributable to Rock-Tenn Company shareholders	$479.7	$727.3	$249.1
Less: Distributed and undistributed income available to participating securities	(0.1)	(0.2)	(0.8)
Distributed and undistributed income attributable to Rock-Tenn Company shareholders	$479.6	$727.1	$248.3
Denominator:			
Basic weighted average shares outstanding	143.6	144.0	142.4
Basic earnings per share attributable to Rock-Tenn Company shareholders	$3.34	$5.05	$1.74
Diluted earnings per share:			
Numerator:			
Net income attributable to Rock-Tenn Company shareholders	$479.7	$727.3	$249.1
Less: Distributed and undistributed income available to participating securities	(0.1)	(0.2)	(0.7)
Distributed and undistributed income attributable to Rock-Tenn Company shareholders	$479.6	$727.1	$248.4
Denominator:			

Basic weighted average shares outstanding	143.6	144.0	142.4
Effect of dilutive stock options and non-participating securities	2.4	2.1	1.7
Diluted weighted average shares outstanding	146.0	146.1	144.1
Diluted earnings per share attributable to Rock-Tenn Company shareholders	$3.29	$4.98	$1.72

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Weighted average shares includes 0.3 million and 0.3 million of reserved, but unissued shares at September 30, 2014 and 2013. These reserved shares will be distributed as claims are liquidated or resolved in accordance with the resolution of Smurfit-Stone bankruptcy claims.

Options and restricted stock in the amount of 0.5 million, 0.3 million and 0.6 million common shares in fiscal 2014, 2013 and 2012, respectively, were not included in computing diluted earnings per share because the effect would have been antidilutive. The dilutive impact of the remaining options and restricted stock outstanding in each year were included in the effect of dilutive securities.

Note 3. Other Comprehensive (Loss) Income

The following table summarizes the changes in accumulated other comprehensive loss by component for the fiscal years ended September 30, 2014 and 2013 (in millions):

	Deferred Loss on Cash Flow Hedges	Defined Benefit Pension and Postretirement Plans	Foreign Currency Items	Total [1]
Balance at September 30, 2012	$(0.2)	$(547.8)	$47.5	$(500.5)
Other comprehensive income (loss) before reclassifications	—	190.4	(15.0)	175.4
Amounts reclassified from accumulated other comprehensive loss	—	24.5	—	24.5
Net current period other comprehensive income (loss)	—	214.9	(15.0)	199.9
Balance at September 30, 2013	(0.2)	(332.9)	32.5	(300.6)
Other comprehensive loss before reclassifications	—	(203.9)	(29.0)	(232.9)
Amounts reclassified from accumulated other comprehensive loss	—	38.6	(0.4)	38.2
Net current period other comprehensive loss	—	(165.3)	(29.4)	(194.7)
Balance at September 30, 2014	$(0.2)	$(498.2)	$3.1	$(495.3)

[1] All amounts are net of tax and noncontrolling interest.

ROCK-TENN COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes the reclassifications out of accumulated other comprehensive loss by component for the fiscal years ended September 30, 2014 and 2013 (in millions):

	Years Ended September 30,					
	2014			2013		
	Pretax	Tax	Net of Tax	Pretax	Tax	Net of Tax
Amortization of defined benefit pension and postretirement items [1]						