Ardea Biosciences, Inc./DE
Form 10-Q
May 08, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 10-Q

þ **Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2007

Or

o **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 0-29993

ARDEA BIOSCIENCES, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	94-3200380
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2131 Palomar Airport Road, Suite 300
Carlsbad, CA 92011

Registrant s telephone number including area code:
(760) 602-8422

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 þ No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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 o
No þ

There were 9,376,799 shares of the Registrant s common stock, par value $0.001, outstanding as of March 31, 2007.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

ARDEA BIOSCIENCES, INC.
(formerly IntraBiotics Pharmaceuticals, Inc.)
CONDENSED BALANCE SHEETS
(In thousands, except share and per share data)

	March 31, 2007 (Unaudited)	December 31, 2006 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,908	$ 14,779
Short-term investments	35,390	33,890
Prepaid expenses and other current assets	1,666	845
Total current assets	46,964	49,514
Property and equipment, net	695	726
Total assets	$ 47,659	$ 50,240
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,029	$ 234
Accrued clinical liabilities	4	4
Accrued employee liabilities	244	
Other accrued liabilities	521	938
Total current liabilities	1,798	1,176
Commitments and contingencies (Note 7)		
Stockholders equity:		
Convertible preferred stock, $0.001 par value: 5,000,000 shares authorized; 300 shares outstanding and $3,000 aggregate liquidation preference at March 31, 2007 and December 31, 2006	1,634	1,634
Common stock, $0.001 par value: 70,000,000 shares authorized at March 31, 2007 and December 31, 2006; 9,376,799 and 9,362,191 shares outstanding at March 31, 2007 and December 31, 2006, respectively	9	9
Additional paid-in capital	283,823	283,594
Accumulated other comprehensive income	1	4
Accumulated deficit	(239,606)	(236,177)
Total stockholders equity	45,861	49,064
Total liabilities and stockholders equity	$ 47,659	$ 50,240

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

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ARDEA BIOSCIENCES, INC.
(formerly IntraBiotics Pharmaceuticals, Inc.)
CONDENSED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
Revenue	$ 893	$
Operating expenses:		
Research and development (includes non-cash stock- based compensation of $28 and $0, respectively)	$ 3,513	7
General and administrative (includes non-cash stock- based compensation of $141 and $135, respectively)	1,544	660
Total operating expenses	5,057	667
Operating loss	(4,164)	(667)
Interest income	611	518
Other income (expense), net	184	(1)
Net loss	(3,369)	(150)
Non-cash dividends on Series A preferred stock	(60)	(60)
Net loss applicable to common stockholders	$ (3,429)	$ (210)
Basic and diluted net loss per share applicable to common stockholders	$ (0.37)	$ (0.02)
Shares used to compute basic and diluted net loss per share applicable to common stockholders	9,373	9,298

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

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ARDEA BIOSCIENCES, INC.
(formerly IntraBiotics Pharmaceuticals, Inc.)
CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
Operating activities		
Net loss	$ (3,369)	$ (150)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock compensation	169	135
Depreciation and amortization	58	
Gain on disposal of property and equipment	(184)	
Change in assets and liabilities:		
Prepaid expenses and other current assets	(821)	83
Other assets		
Accounts payable	795	(2)
Accrued clinical liabilities		(91)
Accrued employee liabilities	244	
Other accrued liabilities	(417)	(51)
Net cash used in operating activities	(3,525)	(76)
Investing activities		
Capital expenditures	(27)	
Proceeds from sale of property and equipment	184	
Purchase of short-term investments	(35,496)	(59,712)
Proceeds from sale or maturity of short-term investments	33,993	57,730
Net cash used in investing activities	(1,346)	(1,982)
Net decrease in cash and cash equivalents	(4,871)	(2,058)
Cash and cash equivalents at beginning of the period	14,779	2,772
Cash and cash equivalents at end of the period	$ 9,908	$ 714
Supplemental disclosure of non-cash information:		
Issuance of common stock dividend on Series A preferred stock	$ (60)	$ (60)

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

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ARDEA BIOSCIENCES, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying condensed financial statements are unaudited and have been prepared by Ardea Biosciences, Inc. (the Company) in accordance with the rules and regulations of the Securities and Exchange Commission for interim financial information, and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.

Certain information and footnote disclosures normally included in the Company s annual audited financial statements (as required by accounting principles generally accepted in the United States) have been condensed or omitted. The interim condensed financial statements, in the opinion of management, reflect all adjustments (consisting entirely of normal recurring adjustments) necessary for a fair presentation of the Company s financial position as of March 31, 2007, the results of its operations for the three months ended March 31, 2007 and 2006 and cash flows for the three months ended March 31, 2007 and 2006.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the entire fiscal year. These interim condensed financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2006, which are contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 2, 2007. The condensed balance sheet as of December 31, 2006 is derived from such audited financial statements.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, including amounts accrued for stock-based compensation.

The Company s estimate of accrued costs is based on historical experience, information received from third parties and on various other assumptions that are believed 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 could therefore differ materially from those estimates under different assumptions or conditions.

Note 2. Stock-Based Compensation

Stock Plans

The Company s 2004 Stock Incentive Plan (the 2004 Plan) was adopted in May 2004, and replaced the 2000 Equity Incentive Plan (the 2000 Plan), which in turn had replaced the 1995 Incentive Stock Plan (the 1995 Plan) collectively the Predecessor Plans). The termination of the Predecessor Plans had no effect on the options that were granted thereunder. The terms of awards granted under the Predecessor Plans were substantially similar to those granted under the 2004 Plan. The 2004 Plan allows for the granting of options to purchase stock, stock bonuses and rights to acquire restricted stock of up to 2,050,000 shares of common stock to employees, consultants, and directors. The number of shares of common stock available for issuance under the 2004 Plan shall automatically increase on the first trading day of January each calendar year during the term of the 2004 Plan, beginning with calendar year 2005. The shares available for issuance under the 2004 Plan were increased by 543,302 on January 1, 2006, and 547,027 on January 1, 2007. All options granted under the 2004 Plan must have exercise prices equal to the fair market value of the common stock on the option grant date, and are to have a term not greater than 10 years from the grant date. Options granted under the 2004 Plan vest ratably over periods ranging from 3 months to six years. Options granted under the Predecessor Plans vest ratably over periods ranging from 18 months to six years.

The 2002 Non-Officer Equity Incentive Plan (the 2002 Plan) was adopted in August 2002 and allows for the granting of stock awards, stock bonuses and rights to acquire restricted stock of up to 56,250 shares of common stock to employees of the Company who are not officers, to executive officers not previously employed by the Company as an inducement to entering into an employment contract with the Company, and to consultants of the Company. All options are to have a term not greater than 10 years from the grant date.

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To cover the exercise of vested options the Company issues new shares from its authorized but unissued share pool. As of March 31, 2007, there were 1,803,337 and 56,250 shares of common stock available for issuance (grant) under the 2004 Plan and the 2002 Plan, respectively.

No cash proceeds were received from the sales of common stock under employee option plans for the three months ended March 31, 2007 or March 31, 2006. No income tax benefits were realized from the sales of common stock during the three months ended March 31, 2007. In accordance with SFAS 123 (R), the Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

Adoption of SFAS No. 123 (R)

Effective January 1, 2006, the Company adopted Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) 123(R) Share-Based Payment , a revision of SFAS 123, Accounting for Stock-Based Compensation which superseded Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. SFAS 123(R) establishes standards for the accounting for transactions where an entity exchanges its equity instruments for goods or services. The principal focus of SFAS 123(R) is the accounting for transactions in which an entity obtains employee services in share-based payment transactions, and where the measurement of the cost of employee (or member of the Board of Directors) services received in exchange for an award of equity instruments is based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee (or director) is required to provide service in exchange for the award the requisite service period and unless observable market prices for the same or similar instruments are available, will be estimated using option-pricing models adjusted for the unique characteristics of the instruments. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Stock Compensation Expense

Under SFAS 123(R), we determined the appropriate fair value model to be used for valuing share-based payments and the amortization method for compensation cost. The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company s Consolidated Financial Statement for the three months ended March 31, 2007 reflects the impact of SFAS 123(R). During the three months ended March 31, 2007 and 2006, the Company recognized $169,000 and $136,000, respectively, in compensation expense related to options granted to employees and directors. There were no tax benefits from share-based compensation since the Company has substantial tax loss carry forwards and sustained a loss to stockholders for the three months ended March 31, 2007. The impact of stock based compensation on both basic and diluted earnings per share for the three months ended March 31, 2007 was $0.02.

At March 31, 2007, the total compensation cost related to unvested stock-based awards granted to employees under the stock option plans but not yet recognized was approximately $2.1 million, after estimated forfeitures. The cost will be recognized on a straight-line basis over an estimated weighted average period of approximately 3.5 years for stock options and will be adjusted if necessary for forfeitures and cancellations.

Determining Fair Value

Valuation and amortization method The Company estimates the fair value using a Black-Scholes option pricing formula and a single option award approach. This fair value is then amortized ratably over the requisite service periods of the awards, which is generally the vesting period.

Expected Term The expected term of options is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; which results from certain groups of employees exhibiting different behavior.

Expected Volatility The Company s expected volatility for the quarter ended March 31, 2007 is based on Company s historical volatility.

Risk-Free Interest Rate The risk-free interest rate used in the Black-Scholes option valuation method is based on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term of the option.

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Expected Dividend The dividend yield reflects that the Company has not paid any dividends on common stock and has no intention to pay dividends on common stock in the foreseeable future.

Estimated Forfeiture Because of the cessation of operations from June of 2005 through December of 2006, the Company has no reliable information at this time to estimate forfeiture.

In the three months ended March 31, 2007, the fair value of each option grant was estimated on the date of grant using the Black-Scholes option valuation model using a dividend yield of 0% and the following weighted average assumptions:

	Three Months Ended March 31, 2007
Risk-free interest rate	4.66%
Volatility	0.15
Dividend yield	0.00%
Expected life of option	6.1 years

Stock options for 734,000 shares were granted to employees during the three months ended March 31, 2007. There were no post-vesting restrictions.

Stock Options and Awards Activities

The following is a summary of the Company s stock option activity under the stock option plans as of March 31, 2007 and related information:

	Outstanding Options			
	Number of Shares	Weighted Average Exercise Price	Remaining Contract Life	Aggregate Intrinsic Value (000 s)
Balance at December 31, 2006	1,345,834	$5.45	8.58	1,763,077
Granted	734,000	$4.63	9.76	437,740
Exercised				
Forfeitures and cancellations				
Balance at March 31, 2007	2,079,834	$5.16	8.67	$2,200,817
Vested and expected to Vest at March 31, 2007	2,079,834	$5.16	8.67	$2,200,817
Exercisable at March 31, 2007	444,583	$7.51	5.8	$ 608,827

The weighted-average grant date fair value of options granted for the three months ended March 31, 2007 was $4.63. The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s closing stock price of $5.25 at March 31, 2007, which would have been received by option holders had all option holders exercised their options that were in-the-money as of that date. The total number of in-the-money options exercisable as of March 31, 2007 was 270,834 shares. The aggregate intrinsic value of options exercised during the three month period ending March 31, 2007 was zero, since there were no options exercised.

The exercise prices for options outstanding and exercisable as of March 31, 2007 and their weighted average remaining contractual lives were as follows:

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	Options Outstanding			Options exercisable	
Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$ 2.76	203,334	3.76	2.76	203,334	$ 2.76
$ 3.50	37,500	8.87	3.50	37,500	$ 3.50
$ 3.90	865,000	9.73	3.90	10,000	$ 3.90
$ 4.08	20,000	7.76	4.08	20,000	$ 4.08
$ 4.24	424,000	9.76	4.24		$ 4.24
$ 5.20	190,000	9.96	5.20		$ 5.20
$ 5.10	120,000	9.96	5.10		$ 5.10
$13.06	100,000	7.1	13.06	70,833	$13.06
$13.93	40,000	7.2	13.93	36,666	$13.93
$16.49	80,000	6.84	16.49	66,250	$16.49
Totals	2,079,834	8.67	5.16	444,583	$ 7.51

Note 3. Comprehensive Income (Loss)

The components of comprehensive loss in each period presented are as follows:

	Three Months Ended March 31,	
	2007	2006
	(In thousands)	
Net loss	$ (3,369)	$ (150)
Unrealized gain (loss) on available-for-sale securities	(3)	16
Comprehensive loss	$ (3,372)	$ (134)

Note 4. Net Income (Loss) Per Share

Basic and diluted net income (loss) per share applicable to common stockholders is presented in accordance with Financial Accounting Standards Board Statement No. 128, *Earnings Per Share,* and is calculated using the weighted-average number of shares of common stock outstanding during the period. Net profit or loss per share applicable to common stockholders includes the impact of potentially dilutive securities (stock options, warrants and convertible preferred stock). As the Company s potentially dilutive securities were anti-dilutive for all loss periods presented, they are not included in the calculations of diluted net loss per share applicable to common stockholders for those loss periods. Potentially dilutive shares used to compute 2007 first quarter basic and diluted net income per share were calculated using the net exercise method. The total number of shares underlying the stock options, warrants and convertible preferred stock excluded from the calculations of net income (loss) per share applicable to common stockholders was 3,941,027 and 2,436,535 for the three months ended March 31, 2007 and 2006.

Note 5. Stockholders Equity

The Company s quotation for its common stock appears in the Pink Sheets under the trading symbol ARDC.

In January 2007, the Company issued 14,608 shares of common stock in connection with dividends payable to holders of preferred stock on December 31, 2006.

Note 6. Acquisition

On December 21, 2006, the Company acquired intellectual property and other assets related to three distinct pharmaceutical research and development programs from Valeant, hired a new senior management team, including Barry D. Quart, Pharm.D., who replaced Denis Hickey as Chief Executive Officer, and changed its name from IntraBiotics Pharmaceuticals, Inc. to Ardea

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Biosciences, Inc. With these developments, the Company is pursuing pharmaceutical research and development focused on the development of novel treatments for viral diseases, cancer and inflammatory diseases. The Company is providing research services to Valeant in connection with a preclinical program in the field of neuropharmacology pursuant to a services agreement with Valeant. This agreement, which has a two-year term subject to Valeant s option to terminate the agreement after the first year, provides that the Company will receive quarterly payments totaling up to $3.5 million per year and up to $1.0 million in milestone payments.

Under the Asset Purchase Agreement with Valeant, the Company is also obligated to make development-based milestone payments and sales-based royalty payments to Valeant. There is one set of milestones for the 800 and 900 Series Programs and a separate set of milestones for the 100 Series Program (see ITEM 2, Recent Developments for discussion of these programs). Assuming the successful commercialization of a product incorporating a compound from the 800 Series Program or the 900 Series Program, the milestone payments for these two programs combined could total $25 million. For the 100 Series Program, milestone payments could total $17 million, assuming the successful commercialization of a product from that program. For each program, milestones are paid only once regardless of how many compounds are developed or commercialized. In each program, the first milestone payment would be due after the completion of a proof-of-concept clinical study in patients, and more than half of the total milestone payments would be due after regulatory approval. The royalty rates on all products are in the mid-single digits.

As part of the purchase of assets from Valeant, the Company received fixed assets valued at approximately $4.3 million and goodwill and intangible assets valued at $800,000. For these assets, the Company paid no upfront consideration and did not assume any liabilities except for liabilities under certain contracts related to the assets. The Company s costs for professional fees in connection with the transaction were approximately $500,000. The transaction was initially recorded at fair market value as follows:

Fixed assets of approximately $4.3 million,

Intangible assets of approximately $300,000, and

Goodwill of approximately $500,000.

These assets were acquired without upfront consideration. Therefore, the fair value of the assets acquired exceeded the cost of upfront consideration paid. The excess of $4.6 million (net of transaction costs) was allocated in its entirety as reductions to the amounts initially assigned to the acquired non-current assets pursuant to paragraph 44 of Statement of Financial Accounting Standards No. 141 (SFAS 141).

Note 7. Commitments and contingencies

As discussed in footnote 6, under the Asset Purchase Agreement with Valeant, the Company is obligated to make development-based milestone payments and sales-based royalty payments to Valeant. The contingent liability of up to $42 million in milestone payments for the 800, 900 and 100 Series Programs was considered a liability in the ordinary course of business, to be recorded when the contingency is resolved and consideration is issued or becomes assumable.

In December 2006, the Company entered into a lease for its Costa Mesa research facility. This leased property, which is located at 3300 Hyland Avenue, Costa Mesa, California 92626, is being used in connection with the Company s research and development activities. The facility occupies approximately 64,000 square feet of laboratory and office space and the monthly base rent is approximately $90,000. The lease expires in March 2008.

The Company recently entered into a lease for 2,900 square feet of space in Carlsbad, California, at a monthly rent approximating $3,000 after sublease income. This facility houses the Company s corporate offices.

Note 8. Legal Proceedings

Currently, we are not a party to any pending legal proceedings and are not aware of any proceeding against us contemplated by any governmental authority.

Note 9. Recent Accounting Pronouncements

In July 2006, the FASB issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48), which is a change in accounting for income

taxes. FIN 48 specifies

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how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not anticipate that this FASB will have any material impact on our financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), Fair Value Measurements. Among other requirements, SFAS No. 157 defines fair value and establishes a framework for measuring fair value and also expands disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 is effective beginning the first fiscal year after November 15, 2007. The Company is currently evaluating the impact of SFAS No. 157 on its financial position and results of operations.

In September 2006, the SEC issued SAB No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The guidance is applicable for fiscal years ending after November 15, 2006. We do not anticipate that this SAB will have any material impact on our financial condition or results of operations.

In September, 2006, the FASB issued SFAS No 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (FAS 158). FAS 158 requires companies to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other postretirement plans in their financial statements. As we do not have defined benefit pensions or other postretirement plans, FAS 158 will have no impact on our financial statements or results of operations. In July 2006, the FASB issued FASB Staff Position (FSP) No. FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction, that provides guidance on how a change or a potential change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for the lease. This staff position was adopted by the Company on January 1, 2007. The Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities . The objective of this statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of SFAS 159, but does not expect adoption to have a material impact on its consolidated financial position, results of operations or cash flows.

Note 10. Income Taxes

We adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109,* or FIN 48, on January 1, 2007. We did not have any unrecognized tax benefits and there was no effect on our financial condition or results of operations as a result of implementing FIN 48.

We file income tax returns in the U.S. federal jurisdiction and in California.

Our policy is that we recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of FIN 48, we did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the quarter. Our effective tax rate is zero because of current losses and tax carry forwards.

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

The following discussion and analysis of our financial condition and results of operations should be read together with our financial statements and related notes appearing elsewhere in this Form 10-Q and the audited financial statements and notes thereto as of and for the year ended December 31, 2006 included with our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or SEC. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. The actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including but not limited to those set forth under Risk Factors. All forward-looking statements included in this document are based on information available to us on the date of this document and we assume no obligation to update any forward-looking statements contained in this Form 10-Q.

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Overview and Business Strategy

Ardea is focused on the development of small-molecule drugs that address large pharmaceutical markets. We plan to source these development candidates from both our internal drug discovery programs and our continued in-licensing efforts. Our initial therapeutic areas of focus are viral diseases, cancer and inflammatory diseases. We believe that we are well-positioned to create shareholder value through our development activities given our ability to achieve clinical proof-of-concept relatively quickly and cost-effectively in these disease areas. The Company currently is pursuing three development programs and has a goal of initiating clinical studies on three or more compounds this year. These development programs include the following:

800 Series Program. Our 800 Series Program is our lead program and is directed toward the discovery and development of non-nucleoside reverse transcriptase inhibitors (NNRTIs) for the potential treatment of HIV. The lead product candidate from this program is RDEA806. *In vitro* preclinical tests have shown RDEA806 to be a potent inhibitor of a wide range of HIV viral isolates, including isolates that are resistant to efavirenz (Sustiva®, Bristol-Myers Squibb), the most widely prescribed NNRTI, in addition to other currently available NNRTIs. Based on preclinical data, we anticipate that this compound could be amenable to a patient-friendly oral dosing regimen, may have limited pharmacokinetic interactions with other drugs, and may be readily co-formulated with other HIV antiviral drugs. We initiated a Phase I clinical study of RDEA806 in March 2007 and plan to report initial results from this study in the third quarter of 2007.

900 Series Program. Our 900 Series Program, which is in preclinical development, is also directed toward the discovery and development of NNRTIs for the potential treatment of HIV. The compounds in our 900 Series Program are from a chemical class that is distinct from the chemical class being investigated in our 800 Series Program. Based on early preclinical data, we believe that the compounds in our 900 Series Program may have the potential to share certain of the positive attributes of the compounds in our 800 Series Program, but also appear to have even greater activity against a wide range of drug-resistant viral isolates. We plan to select one or more development candidates from this program in the second quarter of 2007 and to initiate a clinical study in the fourth quarter of 2007.

100 Series Program. Our 100 Series Program, which is in preclinical development, is directed toward the discovery and development of small-molecule kinase inhibitors for the potential treatment of both cancer and inflammation. RDEA119 is our lead development candidate from our 100 Series Program. *In vitro* preclinical tests have shown RDEA119 to be a potent and selective inhibitor of mitogen-activated ERK kinase, or MEK, which is believed to play an important role in cancer cell proliferation, apoptosis and metastasis, as well as inflammatory cell signaling. *In vivo* preclinical tests have shown RDEA119 to have potent anti-tumor activity. In other preclinical tests, RDEA119 and one of our follow-on MEK inhibitors have been shown to have potent anti-inflammatory activity. Finally, preclinical data suggest that RDEA119 may have favorable pharmaceutical properties, including the potential for convenient oral dosing. We plan to initiate a Phase I clinical study of RDEA119 in the third quarter of 2007.

Market Opportunity

We believe that there is a significant market opportunity for our products, should they be successfully developed, approved and commercialized.

In 2005, the worldwide market for HIV antivirals was approximately $8.0 billion, according to IMS Health Incorporated. While the treatment of HIV has improved dramatically over the past decade, we believe that there remains a significant need for new treatments that are effective against drug-resistant virus, well-tolerated and convenient to take. We believe that our 800 and 900 Series NNRTIs have the potential to meet this market need.

We also believe that there is a growing interest in the potential for targeted therapies, including kinase inhibitors, for the treatment of both cancer and inflammatory disease. In 2005, the worldwide market for targeted therapies for cancer was $7.5 billion, according to Datamonitor plc, and the worldwide market for targeted therapies for inflammatory diseases was more than $8.0 billion, according to IMS Health Incorporated. Given the role that MEK appears to play in cancer and inflammatory diseases and the increasing preference for oral therapies, we believe that

RDEA119 and our follow-on MEK inhibitors, if successfully developed, approved and commercialized, could participate in these growing markets.

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Company History

We were incorporated in the State of Delaware in 1994. From our inception through May 5, 2005, we devoted substantially all of our efforts to the research and development of anti-microbial drugs and generated no product revenues. From the fourth quarter of 2002 until June 2004, we focused our attention on developing Iseganan, an anti-microbial peptide, for the prevention of ventilator-associated pneumonia, or VAP. In June 2004, we discontinued our clinical trial of Iseganan for the prevention of VAP following a recommendation of our independent data monitoring committee. Subsequently, we terminated the Iseganan development program, reduced our work force, and evaluated strategic alternatives, including potential mergers, acquisitions, in-licensing opportunities and liquidation.

On May 5, 2005, after considering a variety of strategic alternatives, none of which was determined by our management and Board of Directors to be in the best interests of us and our stockholders, our Board of Directors decided to reduce operating expenses to a minimum appropriate level. In accordance with these plans, we terminated all of our remaining regular employees on June 15, 2005, engaged Hickey & Hill, Inc. of Lafayette, California, a firm specializing in managing companies in transition, to assume the responsibilities of our day-to-day administration, and appointed Denis Hickey of Hickey & Hill, Inc. as our Chief Executive Officer and Chief Financial Officer.

From June 15, 2005 until December 21, 2006, Denis Hickey handled the administration of our affairs, while our Board of Directors and selected consultants searched for and evaluated strategic alternatives for our business. During that period, we evaluated several strategic alternatives in the biotechnology industry with the support of consultants, including Barry D. Quart, Pharm.D., our current President and Chief Executive Officer, and the active participation of our Board of Directors.

Transaction with Valeant

On December 21, 2006, we acquired intellectual property and other assets related to three distinct pharmaceutical research and development programs (the 800 Series Program, the 900 Series Program, and the 100 Series Program) from Valeant Research & Development, Inc., or Valeant, pursuant to an Asset Purchase Agreement, hired a new senior management team, including Barry D. Quart, Pharm.D., who replaced Denis Hickey as Chief Executive Officer, and changed our name from IntraBiotics Pharmaceuticals, Inc. to Ardea Biosciences, Inc. With these developments, we are pursuing pharmaceutical research and development focused on novel treatments for viral diseases, cancer and inflammatory diseases, as discussed above.

In consideration for the purchased assets from Valeant, subject to certain conditions, Valeant has the right to receive development-based milestone payments and sales-based royalty payments from us. There is one set of milestones for the 800 and 900 Series Programs and a separate set of milestones for the 100 Series Program. Assuming the successful commercialization of a product incorporating a compound from the 800 Series Program or the 900 Series Program, the milestone payments for these two programs combined could total $25 million. For the 100 Series Program, milestone payments could total $17 million, assuming the successful commercialization of a product from that program. For each program, milestones are paid only once regardless of how many compounds are developed or commercialized. In each program, the first milestone payment would be due after the completion of a proof-of-concept clinical study in patients, and more than half of the total milestone payments would be due after regulatory approval. The royalty rates on all products are in the mid-single digits. We agreed to further develop the programs with the objective of obtaining marketing approval in the United States, the United Kingdom, France, Spain, Italy and Germany.

Valeant also has the right to exercise a one-time option to repurchase commercialization rights in territories outside the U.S. and Canada to our first NNRTI derived from the acquired intellectual property to advance to Phase III. If Valeant exercises this option, which it can do following the completion of Phase IIb but prior to the initiation of Phase III, the Company would be responsible for completing the Phase III studies and for the registration of the product in the U.S. and European Union. Valeant would pay us a $10.0 million option fee, up to $21.0 million in milestone payments based on regulatory approvals, and a mid-single-digit royalty on product sales in the Valeant territories.

We also entered into a research services agreement with Valeant under which we will advance a preclinical program in the field of neuropharmacology on behalf of Valeant. Under the agreement, which has a two-year term subject to Valeant s option to terminate the agreement after the first year, Valeant will pay us quarterly payments totaling up to $3.5 million per year to advance the program, and we are entitled to development-based milestone

payments of up to $1.0 million. Valeant will own all intellectual property under this research program. We also entered into a lease agreement for space formerly held by Valeant.

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The assets we acquired from Valeant include equipment, intellectual property, contracts, permits, licenses and items necessary for us to pursue our three pharmaceutical research and development programs. The fixed assets we received from Valeant were valued at approximately $4.3 million, and goodwill and intangible assets were valued at approximately $800,000. For these assets, we paid no upfront consideration and assumed no liabilities except for liabilities under certain contracts related to the assets. Our costs for professional fees in connection with the transaction were approximately $500,000. Since the fair value of the assets acquired exceeded the cost of the upfront consideration paid, we initially recorded the excess of $4.6 million (net of transaction costs) as negative goodwill and then subsequently allocated this amount in its entirety to reduce the amounts initially assigned to the acquired non-current assets pursuant to paragraph 44 of Statement of Financial Accounting Standards No. 141 (SFAS 141). As a result, $500,000 of gross fixed assets associated with the transaction remains on our records. We also have a contingent liability of up to $42 million related to our obligations to make milestone payments for the 800, 900 and 100 Series Programs, to be recorded if and when the milestones become payable.

Financial Outlook

On March 31, 2007, the Company had a total of $45.3 million in cash, cash equivalents, and short-term investments and recorded liabilities of $1.8 million. The Company continues to expect negative cash flow of between $16 million and $20 million for all of 2007, and to end 2007 with approximately $28 million to $32 million in cash, cash equivalents and short-term investments. We currently expect that our current cash resources will fund operations through 2008. Actual cash usage may vary as a result of costs associated with any strategic endeavors of the Company. There can be no assurance that such cash projections will be achieved, as actual expenditures and interest income may differ significantly from projected levels.

We intend that the following discussion of our results of operations and financial condition will provide information to assist in the understanding of our financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect our financial statements.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. Management believes the following critical accounting policies reflect its more significant estimates and assumptions used in the preparation of the financial statements. We review the accounting policies used in our financial statements on a regular basis.

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities and expenses, and related disclosures. On an ongoing basis, we evaluate these estimates, including those related to clinical trial accruals, income taxes, restructuring costs and stock-based compensation. Estimates are based on historical experience, information received from third parties and on various other assumptions that are believed 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 could therefore differ materially from those estimates under different assumptions or conditions.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) 123(R) Share-Based Payment , a revision of SFAS 123, Accounting for Stock-Based Compensation which superseded Accounting Principles Board (APB) Opinion No. 25, A