Jaguar Animal Health, Inc.
Form 10-Q
May 15, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2017

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 001-36714

JAGUAR ANIMAL HEALTH, INC.

(Exact name of registrant as specified in its charter)

Delaware	**46-2956775**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

201 Mission Street, Suite 2375

San Francisco, California 94105

(Address of principal executive offices, zip code)

(415) 371-8300

(Registrant s telephone number, including area code)

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

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 Exchange Act.

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

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. x

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

As of May 15, 2017, there were 14,440,608 shares of common stock, par value $0.0001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Financial Statements

JAGUAR ANIMAL HEALTH, INC.

CONDENSED BALANCE SHEETS

		March 31, 2017 (Unaudited)		December 31, 2016 (1)
Assets				
Current assets:				
Cash and cash equivalents	$	1,205,061	$	950,979
Restricted cash		21,192		511,293
Accounts receivable				4,963
Other receivable		288,166		
Due from former parent		221,422		299,648
Inventory		392,640		412,754
Deferred offering costs		65,078		72,710
Prepaid expenses		387,912		302,694
Total current assets		2,581,471		2,555,041
Property and equipment, net		870,914		885,945
Other assets		122,163		122,163
Total assets	$	3,574,548	$	3,563,149
Liabilities, Convertible Preferred Stock and Stockholders Deficit				
Current liabilities:				
Accounts payable	$	1,465,494	$	517,000
Deferred collaboration revenue		2,088,989		
Deferred product revenue		208,258		224,454
Convertible notes payable		150,000		150,000
Accrued expenses		1,266,347		582,522
Warrant liability		1,252,620		799,201
Current portion of long-term debt		1,994,015		1,919,675
Total current liabilities		8,425,723		4,192,852
Long-term debt, net of discount		1,332,703		1,817,526
Deferred rent		7,114		6,956
Total liabilities	$	9,765,540	$	6,017,334
Commitments and Contingencies (See Note 6)				
Stockholders Deficit:				
Preferred stock: $0.0001 par value, 10,000,000 shares authorized at March 31, 2017 and December 31, 2016; no shares issued and outstanding at March 31, 2017 and December 31, 2016.				
		1,443		1,401

Common stock: $0.0001 par value, 50,000,000 shares authorized at March 31, 2017 and December 31, 2016; 14,424,128 and 14,007,132 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively.				
Additional paid-in capital		38,959,031		37,980,522
Accumulated deficit		(45,151,466)		(40,436,108)
Total stockholders deficit		(6,190,992)		(2,454,185)
Total liabilities, convertible preferred stock and stockholders deficit	$	3,574,548	$	3,563,149

(1) The condensed balance sheet at December 31, 2016 is derived from the audited financial statements at that date included in the Company s Form 10-K filed with the Securities and Exchange Commission on February 15, 2017.

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

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JAGUAR ANIMAL HEALTH, INC.

CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Unaudited)

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
Product revenue	$ 74,544	$ 38,146
Collaboration revenue	747,866	
Total revenue	822,410	38,146
Operating Expenses		
Cost of product revenue	16,145	18,368
Research and development expense	1,255,452	1,751,741
Sales and marketing expense	122,912	164,413
General and administrative expense	3,303,503	1,788,385
Total operating expenses	4,698,012	3,722,907
Loss from operations	(3,875,602)	(3,684,761)
Interest expense	(180,072)	(284,236)
Other income/(expense)	1,448	(15,207)
Change in fair value of warrants	(453,419)	
Loss on extinguishment of debt	(207,713)	
Net loss and comprehensive loss	$ (4,715,358)	$ (3,984,204)
Net loss per share, basic and diluted	$ (0.33)	$ (0.43)
Weighted-average common shares outstanding, basic and diluted	14,157,351	9,307,354

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

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JAGUAR ANIMAL HEALTH, INC.

CONDENSED STATEMENT OF CHANGES IN COMMON STOCK, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT

(Unaudited)

	Series A Convertible Preferred Stock		Common Stock		Additional paid-in capital	Accumulated deficit	Total Stockholders Deficit
	Shares	Amount	Shares	Amount			
Balances - December 31, 2015		$	8,124,923	$ 812	$ 30,100,613	$ (25,702,328)	$ 4,399,097
Issuance of common stock in a secondary public offering, net of discounts and commissions of $373,011 and offering costs of $496,887 February 2016			2,000,000	200	4,129,902		4,130,102
Issuance of common stock in a private investment in public entities offering, net of offering costs of $105,398 June 2016.			2,027,490	203	2,571,099		2,571,302
Issuance of common stock in a private investment in public entities offering October 2016			170,455	17	149,983		150,000
Issuance of common stock and equity warrants in a private investment in public entities offering, net of warrant liability of $700,001 and net of offering costs of $96,833 November 2016			1,666,668	167	203,000		203,167
Warrants, issued in conjunction with debt extinguishment					108,000		108,000
Issuance of common stock in exchange for vested restricted stock units			17,596	2	(2)		
Stock-based compensation					717,927		717,927
Net and comprehensive loss						(14,733,780)	(14,733,780)
Balances - December 31, 2016		$	14,007,132	$ 1,401	$ 37,980,522	$ (40,436,108)	$ (2,454,185)
Issuance of common stock in a private investment in public entities offering, net of offering costs of $7,632.			416,996	42	542,760		542,802
Stock-based compensation					228,036		228,036

Warrants, issued in conjunction with debt extinguishment			207,713		207,713
Net and comprehensive loss				(4,715,358)	(4,715,358)
Balances - March 31, 2017	$ 14,424,128	$ 1,443	$ 38,959,031	$ (45,151,466)	$ (6,190,992)

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

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JAGUAR ANIMAL HEALTH, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
Cash Flows from Operating Activities		
Net loss	$ (4,715,358)	$ (3,984,204)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation expense	15,031	7,878
Loss on extinguishment of debt	207,713	
Stock-based compensation	228,036	103,542
Amortization of debt issuance costs and debt discount	96,772	131,123
Change in fair value of warrants	453,419	
Changes in assets and liabilities		
Accounts receivable - trade	4,963	43,071
Other receivable	(288,166)	
Inventory	20,114	(39,760)
Prepaid expenses	(85,218)	(301,660)
Deferred offering costs	7,632	
Due from parent	78,226	653
Deferred collaboration revenue	2,088,989	
Deferred product revenue	(16,196)	27,129
Deferred rent	158	1,660
License fee payable		(425,000)
Accounts payable	931,340	101,629
Accrued expenses	683,825	(193,919)
Total cash used in operations	(288,720)	(4,527,858)
Cash Flows from Investing Activities		
Purchase of equipment		(85,723)
Change in restricted cash	490,101	178,740
Total cash provided by investing activities	490,101	93,017
Cash Flows from Financing Activities		
Repayment of long-term debt	(490,101)	(178,740)
Proceeds from issuance of common stock in follow-on secondary public offering		5,000,000
Commissions, discounts and issuance costs associated with the follow-on secondary public offering		(869,898)
Proceeds from issuance of common stock in a private investment in public entities	550,434	
Issuance costs associated with the proceeds from the issuance of common stock in a private investment in public entities	(7,632)	
Total Cash Provided by Financing Activities	52,701	3,951,362
Net increase (decrease) in cash and cash equivalents	254,082	(483,479)
Cash and cash equivalents, beginning of period	950,979	7,697,531
Cash and cash equivalents, end of period	$ 1,205,061	$ 7,214,052

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

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JAGUAR ANIMAL HEALTH, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. Organization and Business

Jaguar Animal Health, Inc. (Jaguar or the Company) was incorporated on June 6, 2013 (inception) in Delaware. The Company was a majority-owned subsidiary of Napo Pharmaceuticals, Inc. (Napo or the Former Parent) until the close of the Company s initial public offering on May 18, 2015. The Company was formed to develop and commercialize first-in-class gastrointestinal products for companion and production animals and horses. The Company s first commercial product, Neonorm Calf, was launched in 2014 and Neonorm Foal was launched in the first quarter of 2016. In September of 2016, the Company began selling the *Croton lechleri* botanical extract (the botanical extract) to an exclusive distributor for use in pigs in China. The Company s activities are subject to significant risks and uncertainties, including failing to secure additional funding in order to timely compete the development and commercialization of products. The Company operates in one segment and is headquartered in San Francisco, California.

On June 11, 2013, Jaguar issued 2,666,666 shares of common stock to Napo in exchange for cash and services. On July 1, 2013, Jaguar entered into an employee leasing and overhead agreement (the Service Agreement) with Napo, under which Napo agreed to provide the Company with the services of certain Napo employees for research and development and the general administrative functions of the Company. On January 27, 2014, Jaguar executed an intellectual property license agreement with Napo pursuant to which Napo transferred fixed assets and development materials, and licensed intellectual property and technology to Jaguar. On February 28, 2014, the Service Agreement terminated and the associated employees became employees of Jaguar effective March 1, 2014. See Note 9 for additional information regarding the capital contributions and Note 4 for the Service Agreement and license agreement details. Effective July 1, 2016, Napo agreed to reimburse the Company for the use of the Company s employee s time and related expenses, including rent and a fixed overhead amount to cover office supplies and copier use (Note 4).

On October 6, 2016, Jaguar signed a non-binding letter of intent (LOI) with Napo potentially to merge the two companies. On February 8, 2017, the Company announced that it had entered into a binding agreement of terms (the Agreement) to merge with Napo. On March 31, 2017, Jaguar entered a definitive merger agreement with Napo. The transaction was approved by the unanimous vote of independent and disinterested members of each of Jaguar s and Napo s Board of Directors. Napo will operate as a wholly-owned subsidiary of Jaguar, focused on human health. The binding financial terms of the merger include a 3-to-1 Napo-to-Jaguar value ratio to calculate the relative ownership of the combined entity. As of January 31, 2017, Napo owned approximately 19% of Jaguar s outstanding shares of common stock. The Agreement sets forth the financial terms of the merger and customary conditions to closing, which include but are not limited to completion of due diligence, receipt of a fairness opinion, and stockholder and other approvals. Additionally, the financial terms of the merger and conditions to closing include provisions that (i) Napo s secured convertible debt shall not exceed $11.3 million and its unsecured debt shall not exceed $6.2 million, and (ii) a third party will invest $3.0 million in the Company for approximately four million shares of newly issued common stock of the Company with the investment proceeds loaned to Napo immediately prior to the consummation of the merger. The merger agreement provides that if the merger fails to close for any reason on or prior to July 31, 2017, other than as a result directly or indirectly of (x) lack of stockholder approval by either party or (y) Napo (i) failing to perform in accordance with the terms and conditions of the Agreement or the merger documents or (ii) failing to abide by or breaching the provisions or representations, warranties and covenants of the Agreement or the merger documents, then, on or before the close of business on August 7, 2017, the Company will be required to issue 2,000,000 shares of its restricted common stock to Napo. On April 18, 2017, the Company filed the preliminary registration statement Form S-4 with the Securities and Exchange Commission for the acquisition of Napo through a merger.

Liquidity

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company has incurred recurring operating losses since inception and has an accumulated deficit of $45,151,466 as of March 31, 2017. The Company expects to incur substantial losses in future periods. Further, the Company s future operations are dependent on the success of the Company s ongoing development and commercialization efforts, as well as the securing of additional financing. There is no assurance that profitable operations, if ever achieved, could be sustained on a continuing basis.

The Company plans to finance its operations and capital funding needs through equity and/or debt financing, collaboration arrangements with other entities, as well as revenue from future product sales. However, there can be no assurance that additional funding will be available to the Company on acceptable terms on a timely basis, if at all, or that the Company will generate sufficient cash from operations to adequately fund operating needs or ultimately achieve profitability. If the Company is unable to obtain an adequate level of financing needed for the long-term development and commercialization of its products, the Company will need to

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curtail planned activities and reduce costs. Doing so will likely have an adverse effect on the Company s ability to execute on its business plan. These matters raise substantial doubt about the ability of the Company to continue in existence as a going concern within one year after issuance date of the financial statements. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

In June 2016, the Company entered into a common stock purchase agreement with a private investor (the CSPA), which provides that, upon the terms and subject to the conditions and limitations set forth therein, the investor is committed to purchase up to an aggregate of $15.0 million of the Company s common stock over the approximately 30-month term of the agreement. As of March 31, 2017 the Company sold 2,444,486 shares for cash proceeds of $3,227,134. The CSPA limits the number of shares that the Company can sell thereunder to 2,027,490 shares, which equals 19.99% of the Company s outstanding shares as of the date of the CSPA (such limit, the 19.99% exchange cap), unless either (i) the Company obtains stockholder approval to issue more than such 19.99% exchange cap or (ii) the average price paid for all shares of the Company s common stock issued under the CSPA is equal to or greater than $1.32 per share (the closing price on the date the CSPA was signed), in either case in compliance with Nasdaq Listing Rule 5635(d). The Company held its 2017 Annual Meeting on May 8, 2017. At the 2017 Annual Meeting, the Company s stockholders voted on the approval, pursuant to Nasdaq Listing Rule 5635(d), of the issuance of an additional 3,555,514 shares of the Company s common stock under the CSPA, which when combined with the 2,444,486 shares that the Company has already sold pursuant to the CSPA, equals an aggregate of 6,000,000 shares.

2. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP).

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires the Company s management to make judgments, assumptions and estimates that affect the amounts reported in its financial statements and the accompanying notes. The accounting policies that reflect the Company s more significant estimates and judgments and that the Company believes are the most critical to aid in fully understanding and evaluating its reported financial results are valuation of stock options; valuation of warrant liabilities; impairment of long lived assets; useful lives for depreciation; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax assets; evaluation and measurement of contingencies; and recognition of revenue to capture the estimate driving the period over which Elanco revenue is being recognized. Those estimates could change, and as a result, actual results could differ materially from those estimates.

Deferred Offering Costs

Deferred offering costs are costs incurred in filings of registration statements with the Securities and Exchange Commission. These deferred offering costs are offset against proceeds received upon the closing of the offerings. Deferred costs of $65,078 and $72,710 as of March 31, 2017 and December 31, 2016, respectively, include legal, accounting and filing fees associated with the Company s registration of unissued shares in the CSPA.

Concentration of Credit Risk and Cash and Cash Equivalents

Cash is the financial instrument that potentially subjects the Company to a concentration of credit risk as cash is deposited with a bank and cash balances are generally in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits. The carrying value of cash approximates fair value at March 31, 2017 and December 31, 2016.

Fair Values

The Company s financial instruments include, cash and cash equivalents, accounts payable, accrued expenses, amounts due to Napo, the former parent, warrant liabilities, and debt. Cash is reported at fair value. The recorded carrying amount of accounts payable, accrued expenses and amounts due to Napo approximates their fair value due to their short-term nature. The carrying value of the interest-bearing debt approximates fair value based upon the borrowing rates currently available to the Company for bank loans with similar terms and maturities. See Note 3 for the fair value measurements, and Note 7 for the fair value of the Company s warrant liabilities.

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Restricted Cash

On August 18, 2015, the Company entered into a long-term loan and security agreement with a lender for up to $8.0 million, which provided for an initial loan commitment of $6.0 million. The loan agreement required the Company to maintain a base minimum cash balance of $4.5 million until the Company met certain milestones and/or when the Company begins making principal payments. On December 22, 2015, the Company achieved certain milestones and the base minimum cash balance was reduced to $3.0 million. Aggregate principal payments of $2,978,808 further reduced the restricted cash balance to $21,192 as of March 31, 2017. Restricted cash has been classified within current assets as restrictions were fully released on April 1, 2017.

Inventories

Inventories are stated at the lower of cost or market. The Company calculates inventory valuation adjustments when conditions indicate that market is less than cost due to physical deterioration, usage, obsolescence, reductions in estimated future demand or reduction in selling price. Inventory write-downs are measured as the difference between the cost of inventory and market. There have been no write-downs to date.

Property and Equipment

Equipment is stated at cost, less accumulated depreciation. Equipment begins to be depreciated when it is placed into service. Depreciation is calculated using the straight-line method over the estimated useful lives of 3 to 10 years.

Expenditures for repairs and maintenance of assets are charged to expense as incurred. Costs of major additions and betterments are capitalized and depreciated on a straight-line basis over their estimated useful lives. Upon retirement or sale, the cost and related accumulated depreciation of assets disposed of are removed from the accounts and any resulting gain or loss is included in income (loss) from operations.

Long-Lived Assets

The Company regularly reviews the carrying value and estimated lives of all of its long-lived assets, including property and equipment to determine whether indicators of impairment may exist that warrant adjustments to carrying values or estimated useful lives. The determinants used for this evaluation include management s estimate of the asset s ability to generate positive income from operations and positive cash flow in future periods as well as the strategic significance of the assets to the Company s business objectives.

Should an impairment exist, the impairment loss would be measured based on the excess of the carrying amount over the asset s fair value. The Company has not recognized any impairment losses through March 31, 2017.

Research and Development Expense

Research and development expense consists of expenses incurred in performing research and development activities including related salaries, clinical trial and related drug and non-drug product costs, contract services and other outside service expenses. Research and development expense is charged to operating expense in the period incurred.

Revenue Recognition

Product Revenue

Sales of Neonorm Calf and Foal to distributors are made under agreements that may provide distributor price adjustments and rights of return under certain circumstances. Until the Company develops sufficient sales history and pipeline visibility, revenue and costs of distributor sales will be deferred until products are sold by the distributor to the distributor s customers. Revenue recognition depends on notification either directly from the distributor that product has been sold to the distributor s customer, when the Company has access to the data. Deferred revenue on shipments to distributors reflect the estimated effects of distributor price adjustments, if any, and the estimated amount of gross margin expected to be realized when the distributor sells through product purchased from the Company. Company sales to distributors are invoiced and included in accounts receivable and deferred revenue upon shipment. Inventory is relieved and revenue recognized upon shipment by the distributor to their customer. The Company had Neonorm revenues of $44,544 and $38,146 for the three months ended March 31, 2017 and 2016.

Sales of Botanical Extract are recognized as revenue when delivered to the customer. The Company had Botanical Extract revenues of $30,000 and $0 in the three months ended March 31, 2017 and 2016.

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Collaboration Revenue

On January 27, 2017, the Company entered into a licensing, development, co-promotion and commercialization agreement with Elanco US Inc. (Elanco) to license, develop and commercialize Canalevia (Licensed Product), our drug product candidate under investigation for treatment of acute and chemotherapy-induced diarrhea in dogs, and other drug product formulations of crofelemer for treatment of gastrointestinal diseases, conditions and symptoms in cats and other companion animals. The Company grants Elanco exclusive global rights to Canalevia, a product whose active pharmaceutical ingredient is sustainably isolated and purified from the Croton lechleri tree, for use in companion animals. Pursuant to the Elanco Agreement, Elanco will have exclusive rights globally outside the U.S. and co-exclusive rights with the Company in the U.S. to direct all marketing, advertising, promotion, launch and sales activities related to the Licensed Products. Under the terms of the Elanco Agreement, the Company received an initial upfront payment of $2,548,689 and will receive additional payments upon achievement of certain development, regulatory and sales milestones in an aggregate amount of up to $61.0 million payable throughout the term of the Elanco Agreement, as well as product development expense reimbursement, and royalty payments on global sales. The Elanco Agreement specifies that the Company will supply the Licensed Products to Elanco, and that the parties will agree to set a minimum sales requirement that Elanco must meet to maintain exclusivity. Elanco will reimburse the Company for certain development and regulatory expenses related to our planned target animal safety study and the completion of the Canalevia field study for acute diarrhea in dogs. The Company has $288,166 of unreimbursed expenses as of March 31, 2017, which is included on the Company s balance sheet. The Company included the $288,166 in collaboration revenue in the three months ended March 31, 2017 which is included in the Company s statements of operations and comprehensive loss. The $2,548,689 total of the upfront payment is recognized as revenue ratably over the estimated development period of one year resulting in $459,700 in collaboration revenue in the three months ended March 31, 2017 and is included in the Company s statements of operations and comprehensive loss. The difference of $2,088,989 is included in deferred collaboration revenue and the uncollected $288,166 of unreimbursed expenses is included in other receivables in on the Company s balance sheet.

The Company recognizes revenue in accordance with ASC 605 Revenue Recognition , subtopic ASC 605-25 *Revenue with Multiple Element Arrangements* and subtopic ASC 605-28 *Revenue Recognition-Milestone Method* , which provides accounting guidance for revenue recognition for arrangements with multiple deliverables and guidance on defining the milestone and determining when the use of the milestone method of revenue recognition for research and development transactions is appropriate, respectively. For multiple-element arrangements, each deliverable within a multiple deliverable revenue arrangement is accounted for as a separate unit of accounting if both of the following criteria are met: (1) the delivered item or items have value to the customer on a standalone basis and (2) for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in our control. If a deliverable in a multiple element arrangement is not deemed to have a stand-alone value, consideration received for such a deliverable is recognized ratably over the term of the arrangement or the estimated performance period, and it will be periodically reviewed based on the progress of the related product development plan. The effect of a change made to an estimated performance period and therefore revenue recognized ratably would occur on a prospective basis in the period that the change was made.

The Company recognizes revenue under its licensing, development, co-promotion and commercialization agreement from milestone payments when: (i) the milestone event is substantive and its achievability has substantive uncertainty at the inception of the agreement, and (ii) it does not have ongoing performance obligations related to the achievement of the milestone earned. Milestone payments are considered substantive if all of the following conditions are met: the milestone payment (a) is commensurate with either the Company s performance subsequent to the inception of the arrangement to achieve the milestone or the enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the Company s performance subsequent to the inception of the arrangement to achieve the milestone, (b) relates solely to past performance, and (c) is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

The Company records revenue related to the reimbursement of costs incurred under the collaboration agreement where the company acts as principal, controls the research and development activities and bears credit risk. Under the agreement, the Company is reimbursed for associated out-of-pocket costs and for certain employee costs. The gross amount of these pass-through costs is reported in revenue in the accompanying statements of operations and comprehensive loss, while the actual expense for which the Company is reimbursed are reflected as research and development costs.

Determining whether and when some of these revenue recognition criteria have been satisfied often involves assumptions and judgments that can have a significant impact on the timing and amount of revenue the Company will report. Changes in assumptions or judgments or changes to the elements in an arrangement could cause a material increase or decrease in the amount of revenue that the Company reports in a particular period.

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Stock-Based Compensation

The Company s 2013 Equity Incentive Plan and 2014 Stock Incentive Plan (see Note 10) provides for the grant of stock options, restricted stock and restricted stock unit awards.

The Company measures stock awards granted to employees and directors at fair value on the date of grant and recognizes the corresponding compensation expense of the awards, net of estimated forfeitures, over the requisite service periods, which correspond to the vesting periods of the awards. The Company issues stock awards with only service-based vesting conditions, and records compensation expense for these awards using the straight-line method.

The Company uses the grant date fair market value of its common stock to value both employee and non-employee options when granted. The Company revalues non-employee options each reporting period using the fair market value of the Company s common stock as of the last day of each reporting period.

Classification of Securities

The Company applies the principles of ASC 480-10 Distinguishing Liabilities from Equity and ASC 815-40 Derivatives and Hedging Contracts in Entity s Own Equity to determine whether financial instruments such as warrants should be classified as liabilities or equity and whether beneficial conversion features exist. Financial instruments such as warrants that are evaluated to be classified as liabilities are fair valued upon issuance and are remeasured at fair value at subsequent reporting periods with the resulting change in fair value recorded in other income/(expense). The fair value of warrants is estimated using the Black Scholes Merton model and requires the input of subjective assumptions including expected stock price volatility and expected life.

Income Taxes

The Company accounts for income taxes using 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 recognized in the financial statements or in the Company s tax returns. Deferred taxes are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Changes in deferred tax assets and liabilities are recorded in the provision for income taxes. The Company assesses the likelihood that its deferred tax assets will be recovered from future taxable income and, to the extent it believes, based upon the weight of available evidence, that it is more likely than not that all or a portion of deferred tax assets will not be realized, a valuation allowance is established through a charge to income tax expense. Potential for recovery of deferred tax assets is evaluated by estimating the future taxable profits expected and considering prudent and feasible tax planning strategies.

The Company accounts for uncertainty in income taxes recognized in the financial statements by applying a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination by the taxing authorities. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50% likelihood of being realized upon ultimate settlement. The provision for income taxes includes the effects of any resulting tax reserves, or unrecognized tax benefits, that are considered appropriate, as well as the related net interest and penalties.

Comprehensive Loss

Comprehensive loss is defined as changes in stockholders equity (deficit) exclusive of transactions with owners (such as capital contributions and distributions). For the three months ended March 31, 2017 and 2016 there was no difference between net loss and comprehensive loss.

Segment Data

The Company manages its operations as a single segment for the purposes of assessing performance and making operating decisions. The Company is an animal health company focused on developing and commercializing prescription and non-prescription products for companion and production animals.

Basic and Diluted Net Loss Per Common Share

Basic net loss per common share is computed by dividing net loss attributable to common stockholders for the period by the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss attributable to common stockholders for the period by the weighted-average number of common shares, including potential dilutive shares of common stock assuming the dilutive effect of potential dilutive securities. For periods in which the Company reports a net loss, diluted net loss per common share is the same as basic net loss per common share, because their impact would be anti-dilutive to the calculation of net loss per common share. Diluted net loss per common share is the same as basic net loss per common share for the three months ended March 31, 2017 and 2016.

Recent Accounting Pronouncements

In November 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-18, Statement of Cash Flows: Restricted Cash, or ASU 2016-18, that will require entities to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. As a result, entities will no longer present transfers between cash and cash equivalents and restricted cash and restricted cash equivalents in the statement of cash flows. When cash, cash equivalents, restricted cash and restricted cash equivalents are presented in more than one line item on the balance sheet, the new guidance requires a reconciliation of the totals in the statement of cash flows to the related captions in the balance sheet. This reconciliation can be presented either on the face of the statement of cash flows or in the notes to the financial statements. Entities will also have to disclose the nature of their restricted cash and restricted cash equivalent balances. ASU 2016-18 becomes effective for fiscal years beginning after December 15, 2017, and interim periods within those years, with early adoption permitted. Any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period. The adoption of this standard is not expected to have an impact on the Company s financial position or results of operations.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which addresses the following cash flow issues: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years and are effective for all other entities for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the impact of the adoption of ASU No. 2016-15 on our consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which simplifies several aspects of the accounting for employee stock-based payment transactions. The areas for simplification in ASU No. 2016-09 include the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Effective January 1, 2017, the Company adopted ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. Among other requirements, the new guidance requires all tax effects related to share-based payments at settlement (or expiration) to be recorded through the income statement. Previously, tax benefits in excess of compensation cost (windfalls) were recorded in equity, and tax deficiencies (shortfalls) were recorded in equity to the extent of previous windfalls, and then to the income statement. Under the new guidance, the windfall tax benefit is to be recorded when it arises, subject to normal valuation allowance considerations. The adoption of this standard did not have any impact to the Statement of Operations or the Statement of Cash Flows for the three-month periods ended March 31, 2016 or 2017. As of December 31, 2016, the Company had no unrecognized deferred tax assets related to excess tax benefits, and as such, there was no cumulative-effect adjustment to the beginning accumulated deficit. Additionally, the treatment of forfeitures has not changed as the Company is electing to continue its current process of estimating the number of forfeitures. As such, this has no cumulative effect on accumulated deficit.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which replaces the current lease accounting standard. ASU 2016-02 establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statements of operations. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of the new standard on its financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. The objective of ASU 2014-09 is to establish a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and will supersede most of the existing revenue recognition guidance, including industry-specific guidance. The core principle of the new standard is that revenue should be recognized 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. The standard is effective for annual reporting periods beginning after December 15, 2017 and allows for prospective or retrospective application. The Company currently anticipates utilizing the full retrospective method of adoption allowed by the standard, in order to provide for comparative results in all periods presented, and plans to adopt the standard as of January 1, 2018. The Company is currently evaluating the new guidance, however it does not believe the impact will be significant.

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3. Fair Value Measurements

ASC 820 Fair Value Measurements, defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under ASC 820 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under ASC 820 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

- Level 1 Quoted prices in active markets for identical assets or liabilities;

- Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data; and

- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including pricing models, discounted cash flow methodologies and similar techniques.

The following table presents information about the Company s warrant liabilities that were measured at fair value on a recurring basis as of March 31, 2017 and December 31, 2016 and indicates the fair value hierarchy of the valuation:

	Level 1	Level 2	Level 3	Total
As of March 31, 2017 Warrant Liability	$	$	$ 1,252,620	$ 1,252,620

	Level 1	Level 2	Level 3	Total
As of December 31, 2016 Warrant Liability	$	$	$ 799,201	$ 799,201

The change in the estimated fair value of level 3 liabilities is summarized below:

	Beginning Value of Level 3 Liability	Change in Fair Value of Level 3 Liability	Ending Fair Value of Level 3 Liability
For the three months ended March 31, 2017	$ 799,201	$ 453,419	$ 1,252,620

For the three months ended March 31, 2016	$	$	$

The warrants were issued in 2016 and were originally valued on November 29, 2016 using the Black-Scholes-Merton model with the following assumptions: stock price of $0.69, exercise price of $0.75, term of 5.5 years expiring May 2022, volatility of 71.92%, dividend yield of 0%, and risk-free interest rate of 1.87%. The warrants were revalued at December 31, 2016 using the Black-Scholes-Merton model with the following assumptions: stock price of $0.716, exercise price of $0.75, term of 5.41 years expiring May 2022, volatility of 73.62%, dividend yield of 0%, and risk-free interest rate of 2.0%. The warrants were revalued at March 31, 2017 using the Black-Scholes-Merton model with the following assumptions: stock price of $1.00, exercise price of $0.75, term of 5.16 years expiring May 2022, volatility of 78.33%, dividend yield of 0%, and risk-free interest rate of 1.95%.

The change in the fair value of the level 3 warrant liability is reflected in the statement of operations and comprehensive loss for the three months ended March 31, 2017.

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4. Related Party Transactions

Due from former parent

The Company was a majority-owned subsidiary of Napo until May 18, 2015, the date of the Company s IPO. Additionally, Lisa A. Conte, Chief Executive Officer of the Company, is also the Interim Chief Executive Officer of Napo Pharmaceuticals, Inc. The Company has total outstanding receivables (payables) from former parent (Napo) at March 31, 2017 and December 31, 2016 as follows:

	March 31, 2017	December 31, 2016
Due from former parent	$ 221,429	$ 299,819
Royalty payable to former parent	(7)	(171)
Net receivable (payable) to former parent	$ 221,422	$ 299,648

Due from former parent

Employee leasing and overhead allocation

Effective July 1, 2016, Napo agreed to reimburse the Company for the use of the Company s employee s time and related expenses, including rent and a fixed overhead amount to cover office supplies and copier use. The balance of unpaid employee leasing charges due from Napo was $277,