CIPHERGEN BIOSYSTEMS INC
Form 10-Q
May 15, 2006

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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, 2006
OR

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

Commission file number: 000-31617
CIPHERGEN BIOSYSTEMS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	**33-0595156**
(State or other jurisdiction of incorporation of organization)	(I.R.S. Employer Identification Number)
6611 DUMBARTON CIRCLE, FREMONT, CALIFORNIA	**94555**
(Address of principal executive offices)	(ZIP Code)

Registrant s telephone number, including area code: **510-505-2100**

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

Large Accelerated Filer 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 Exchange Act.

Yes o No þ

Number of shares of common stock, $0.001 par value, outstanding as of April 30, 2006: 35,999,131

CIPHERGEN BIOSYSTEMS, INC.
INDEX FOR FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2006

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

CIPHERGEN BIOSYSTEMS, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,384	$ 25,738
Short-term investment		2,240
Accounts receivable, net of allowance for doubtful accounts of $215 and $238, respectively	5,070	5,828
Prepaid expenses and other current assets	1,442	1,746
Inventories	5,006	5,594
Total current assets	35,902	41,146
Property, plant and equipment, net	6,755	7,320
Goodwill	76	76
Other intangible assets, net	2,252	2,417
Other long-term assets	1,760	1,852
Total assets	$ 46,745	$ 52,811
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,390	$ 3,188
Accrued liabilities	5,123	6,298
Deferred revenue	3,857	4,132
Current portion of capital lease obligations	22	21
Equipment financing loan	190	377
Total current liabilities	11,582	14,016
Deferred revenue	524	508
Capital lease obligations, net of current portion	22	28
Long-term debt owed to related party	3,750	2,500
Convertible senior notes, net of discount	28,718	28,586
Other long-term liabilities	597	650
Total liabilities	45,193	46,288

Commitments and contingencies (note 6)		
Stockholders equity:		
Common stock	36	36
Additional paid-in capital	202,945	202,485
Accumulated other comprehensive loss	(171)	(204)
Accumulated deficit	(201,258)	(195,794)
Total stockholders equity	1,552	6,523
Total liabilities and stockholders equity	$ 46,745	$ 52,811

See notes to unaudited condensed consolidated financial statements.

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CIPHERGEN BIOSYSTEMS, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	Three Months Ended March 31,	
	2006	2005
Revenue:		
Products	$ 4,809	$ 4,481
Services	2,255	2,167
Total revenue	7,064	6,648
Cost of revenue:		
Products	2,273	2,112
Services	1,131	1,023
Total cost of revenue	3,404	3,135
Gross profit	3,660	3,513
Operating expenses:		
Research and development	2,992	3,507
Sales and marketing	3,503	5,273
General and administrative	2,279	3,504
Total operating expenses	8,774	12,284
Loss from operations	(5,114)	(8,771)
Interest and other income (expense), net	(236)	(411)
Loss before income taxes	(5,350)	(9,182)
Income tax provision	114	150
Net loss	$ (5,464)	$ (9,332)
Net loss per share, basic and diluted	$ (0.15)	$ (0.32)

Shares used in computing basic and diluted net loss per share	35,999	29,472

See notes to unaudited condensed consolidated financial statements.

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CIPHERGEN BIOSYSTEMS, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (5,464)	$ (9,332)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,367	1,527
Stock-based compensation expense	460	
Amortization of debt discount associated with beneficial conversion feature of convertible senior notes	131	132
Accrued investment income	(5)	(15)
Interest accrued on notes receivable from related parties		(6)
Changes in operating assets and liabilities:		
Accounts receivable, net	765	5,947
Prepaid expenses and other current assets	307	334
Inventories	639	(91)
Other long-term assets	1	(53)
Accounts payable and accrued liabilities	(1,975)	(1,519)
Deferred revenue	(262)	(942)
Other long-term liabilities	(60)	24
Net cash used in operating activities	(4,096)	(3,994)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment, net	(455)	(944)
Liquidation of short-term investment	2,245	
Payment for license related to litigation settlement	(136)	(174)
Net cash provided by (used in) investing activities	1,654	(1,118)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock, net		3
Repayments of notes receivable from stockholders		310
Proceeds of loan from Quest Diagnostics	1,250	
Principal payments on capital lease obligations	(6)	(3)
Repayments of long-term debt	(186)	(300)
Net cash provided by financing activities	1,058	10

Effect of exchange rate changes	30	(232)
Net decrease in cash and cash equivalents	(1,354)	(5,334)
Cash and cash equivalents, beginning of period	25,738	35,392
Cash and cash equivalents, end of period	$ 24,384	$ 30,058
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of fixed assets to inventory	$ 46	$ 52

See notes to unaudited condensed consolidated financial statements.

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CIPHERGEN BIOSYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
March 31, 2006

1. ORGANIZATION AND BASIS OF PRESENTATION

The Company

Ciphergen Biosystems, Inc. (the Company or Ciphergen) is dedicated to translating protein biomarkers and panels of biomarkers into protein molecular diagnostic tests that improve patient care. The Company is also focused on providing collaborative research services through its Biomarker Discovery Center® laboratories for biomarker discovery for new diagnostic tests as well as pharmacoproteomic services for improved drug toxicology, efficacy and theranostic assays. In addition, Ciphergen develops, manufactures and sells a family of ProteinChipâ Systems for life science researchers. These systems enable protein discovery, validation, identification and assay development to provide researchers with predictive, multi-marker assay capabilities and a better understanding of biological function at the protein level. The core technology, which is patented, is Surface Enhanced Laser Desorption/Ionization (SELDI). The systems consist of ProteinChip Readers, ProteinChip Software and related accessories, which are used in conjunction with consumable ProteinChip Arrays. These products are sold primarily to biologists at pharmaceutical and biotechnology companies, and academic and government research laboratories. The Company also offers consulting services, customer support services and training classes to its customers and collaborators.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the interim reporting requirements of Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information required by accounting principles generally accepted in the United States of America for complete financial statements. Therefore, this unaudited financial data should be read in conjunction with the audited consolidated financial statements and accompanying notes contained in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 17, 2006. The unaudited interim financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair statement have been included. In addition, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised), Share-Based Payment, in January 2006 as discussed in note 8. The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany transactions have been eliminated in consolidation. The results of operations for the interim periods shown herein are not necessarily indicative of operating results for the entire year or any other future interim period.

Liquidity

From its inception through March 31, 2006, the Company has financed its operations principally with $218.1 million from the sales of products and services to customers and net proceeds from equity financings totaling approximately $160.8 million including $15.0 million from the sale of 6,225,000 shares of Ciphergen s common stock and a warrant to purchase up to 2,200,000 shares of Ciphergen s common stock to Quest Diagnostics Incorporated (Quest Diagnostics) on July 22, 2005. Ciphergen received $28.1 million of net proceeds from the sale of 4.5% convertible senior notes on August 22, 2003. These notes are due September 1, 2008. In addition, in July 2005, Quest Diagnostics agreed to loan the Company up to $10 million with interest accrued at the prime rate plus 0.5% and paid monthly, solely to fund certain development activities related to the strategic alliance between Ciphergen and Quest Diagnostics, against which the Company had borrowed approximately $3.7 million as of March 31, 2006. Borrowings may be made by the Company in monthly increments of up to approximately $417,000 during the first two years of the alliance, and the loan will be forgiven upon Ciphergen s achievement of certain milestones. Otherwise, amounts outstanding on the loan must be repaid on or before July 22, 2010. (See note 7.) The Company also received $28.0 million from the sale of its BioSepra® business in November 2004. The Company has incurred significant net losses and negative cash flows from operations since inception. At March 31, 2006, the Company had an accumulated deficit of $201.3 million.

Management believes that currently available resources will provide sufficient funds to enable the Company to meet its obligations for at least the next 12 months. Ciphergen currently expects to fund its liquidity needs as well as expenditures for its obligations related to the strategic alliance with Quest Diagnostics and for capital requirements from a combination of available cash, borrowings from Quest Diagnostics, and potential sales of assets and additional equity and/or debt securities. If anticipated operating results are not achieved, however, management believes that planned expenditures may need to be reduced in order to extend the time period over which the currently available resources will be adequate to fund the Company s operations. At such time as the Company requires additional funding, the Company may seek to raise such

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additional funding from various possible sources, including the public equity market, private financings, sales of assets, collaborative arrangements and debt. If additional capital is raised through the issuance of equity or securities convertible into equity, stockholders may experience dilution, and such securities may have rights, preferences or privileges senior to those of the holders of its common stock or convertible senior notes. If the Company obtains additional funds through arrangements with collaborators or strategic partners, it may be required to relinquish its rights to certain technologies or products that it might otherwise seek to retain. There can be no assurance that the Company will be able to obtain such financing, or obtain it on acceptable terms. If Ciphergen is unable to obtain financing on acceptable terms, it may be unable to execute its business plan, it could be required to delay or reduce the scope of its operations, and it may not be able to pay off the convertible senior notes or the loans from Quest Diagnostics if and when they come due.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151, Inventory Costs, an amendment of ARB 43, Chapter 4 . SFAS 151 requires certain inventory costs to be recognized as current period expenses. This standard also provides guidance for the allocation of fixed production overhead costs. This standard is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company adopted this standard beginning in 2006, but its adoption did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (Revised), Share-Based Payment. This standard requires the measurement of all stock-based compensation, including stock options, using the fair value method and the recording of such expense in the Company s consolidated statements of income. Beginning in the first quarter of 2006, Ciphergen adopted SFAS 123(R) under the modified prospective transition method using the Black-Scholes pricing model. Under this new standard, the Company s estimate of compensation expense requires a number of complex and subjective assumptions, including the price volatility of Ciphergen s common stock, employee exercise patterns (expected life of the options), future forfeitures and related tax effects. Although the adoption of SFAS 123(R) had no adverse impact to the Company s balance sheet and cash flows, it adversely affected the Company s net loss and net loss per share. See note 8 for the pro forma net loss and net loss per share amounts for 2005 as if the Company had used a fair-value-based method similar to the methods required under SFAS 123(R) to measure compensation expense for employee stock incentive awards.

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, Share-Based Payment . SAB 107 provides guidance on the initial implementation of SFAS 123(R). In particular, the statement includes guidance related to share-based payment awards for non-employees, valuation methods and selecting underlying assumptions such as expected volatility and expected term. It also provides guidance on the classification of compensation expense associated with such awards and accounting for the income tax effects of those awards upon the adoption of SFAS 123(R). The Company adopted this standard concurrent with its adoption of SFAS 123(R).

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections . SFAS 154 is a replacement of Accounting Principles Board Opinion (APB) No. 20 and SFAS 3. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS 154. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted this standard beginning in 2006.

In September 2005, the FASB issued EITF Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty (EITF 04-13). The issue provides guidance on the circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of APB Opinion No. 29, Accounting for Nonmonetary Transactions. The issue also provides guidance on circumstances under which nonmonetary exchanges of inventory within the same line of business should be

recognized at fair value. EITF 04-13 is effective for transactions completed in reporting periods beginning after March 15, 2006. Adoption of this standard is not expected to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In October 2005, the FASB issued FSP FAS 123(R)-2, Practical Accommodation to the Application of Grant Date as Defined in FAS 123(R) (FSP 123(R)-2). FSP 123(R)-2 provides guidance on the application of grant date as defined in SFAS 123(R). In accordance with this standard, a grant date of an award exists if (a) the award is a unilateral grant, and (b) the key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively

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short time period from the date of approval. The Company s adoption of this standard concurrent with its adoption of SFAS 123(R) did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In November 2005, the FASB issued FSP FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards (FSP 123(R)-3). FSP 123(R)-3 provides an elective alternative method that establishes a computational component to arrive at the beginning balance of the accumulated paid-in capital pool related to employee compensation and a simplified method to determine the subsequent impact on the accumulated paid-in capital pool of employee awards that are fully vested and outstanding upon the adoption of SFAS 123(R). The Company adopted this transition method concurrent with its adoption of SFAS 123(R).

3. INVENTORIES

Inventories consisted of the following (in thousands):

	March 31, 2006	December 31, 2005
Raw materials	$ 1,558	$ 1,775
Work in process	1,410	1,241
Finished goods	2,038	2,578
	$ 5,006	$ 5,594

4. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets consisted of the following (in thousands):

	March 31, 2006			December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Total	Gross Carrying Amount	Accumulated Amortization	Total
Non-amortizing:						
Goodwill	$ 76	$	$ 76	$ 76	$	$ 76
Amortizing:						
Acquired license related to litigation settlement	5,879	3,627	2,252	5,743	3,326	2,417
	$ 5,955	$ 3,627	$ 2,328	$ 5,819	$ 3,326	$ 2,493

During the first three months of 2006, the acquired license related to the Company s litigation settlement in 2003 increased $136,000 as a result of cash payments made by the Company for license fees. Amortization expense for this acquired license for the three month periods ended March 31, 2006 and 2005 was $301,000 and $303,000, respectively. Amortization expense for the acquired license, based on its gross carrying amount at March 31, 2006, is expected to total approximately $907,000 for the remaining nine months of 2006, $1.2 million in 2007, $135,000 in 2008 and zero thereafter. Amortization expense for the acquired license is charged to cost of revenue.

5. WARRANTIES AND MAINTENANCE CONTRACTS

Ciphergen has a direct field service organization that provides service for its products. The Company generally includes a standard 12 month warranty on its ProteinChip Systems, ProteinChip Tandem MS Interfaces and accessories in the form of a maintenance contract upon initial sale, after which maintenance and support may be provided under a separately priced contract or on an individual call basis. The Company substitutes a maintenance contract in place of a standard 12-month warranty on its instruments and accessories upon initial sale. Ciphergen also sells separately priced maintenance (extended warranty) contracts, which are generally for 12 or 24 months, upon

expiration of the initial maintenance contract. Coverage under both the standard and extended maintenance contracts is identical. Revenue for both the standard and extended maintenance contracts is deferred and recognized on a straight line basis over the period of the applicable maintenance contract. Related costs are recognized as incurred.

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Changes in product warranty obligations, including separately priced maintenance obligations, were as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Balance at beginning of period	$ 2,831	$ 3,778
Add: Costs incurred for maintenance contracts	564	706
Revenue deferred for maintenance contracts	1,227	979
Less: Settlements made under maintenance contracts	(564)	(706)
Revenue recognized for maintenance contracts	(1,174)	(1,318)
Balance at end of period	$ 2,884	$ 3,439

6. COMMITMENTS AND CONTINGENCIES

On October 3, 2005, the Company entered into a two year research and license agreement with University College London and UCL BioMedica Plc. (together, UCL) to utilize Ciphergen s suite of proteomic solutions (Deep Proteome , Pattern Track Process and ProteinChip System) to further UCL s ongoing research in ovarian cancer and breast cancer. Under the terms of the agreement, Ciphergen has exclusive rights to license intellectual property resulting from discoveries made during the course of this collaboration for use in developing, manufacturing and selling products and services utilizing the intellectual property. Additionally, Ciphergen will contribute approximately $2.1 million in cash and $652,000 in the form of Ciphergen equipment, software, arrays and consumable supplies as requested by UCL, valued at Ciphergen s list selling price, to cover part of the costs incurred by UCL specifically for this research program. $1.1 million of the cash obligation is to be paid in the first year of the agreement and is non-cancelable. The remainder is to be paid in the second year of the agreement and is cancelable with three months advance notice. As of March 31, 2006, the Company had expensed $583,000, of which $50,000 represented the Company s cost for the arrays and consumables it had provided, and the remaining $533,000 was recorded as an accrued liability.

7. STRATEGIC ALLIANCE WITH QUEST DIAGNOSTICS

On July 22, 2005, the Company entered into a strategic alliance agreement with Quest Diagnostics covering a three year period during which the parties will strive to develop and commercialize up to three diagnostic tests based on Ciphergen s proprietary SELDI ProteinChip technology. Pursuant to the agreement, Quest Diagnostics will have the non-exclusive right to commercialize these tests on a worldwide basis, with exclusive commercialization rights in territories where Quest Diagnostics has a significant presence for up to five years following commercialization. As part of the strategic alliance, there is a royalty arrangement under which Quest Diagnostics will pay royalties to Ciphergen based on fees earned by Quest Diagnostics for applicable diagnostics services, and Ciphergen will pay royalties to Quest Diagnostics based on Ciphergen s revenue from applicable diagnostics products. To date, no such royalties have been earned by either party. Quest Diagnostics and Ciphergen have also entered into a supply agreement under which Ciphergen will sell instruments and consumable supplies to Quest Diagnostics to be used for performing diagnostics services. In addition, for an aggregate purchase price of $15 million, Quest Diagnostics purchased 6,225,000 shares of Ciphergen s common stock, or approximately 17.4% of shares outstanding after the transaction, and a warrant having a term of five years to purchase up to an additional 2,200,000 shares for $3.50 per share. The warrant was valued at approximately $2.2 million based on the fair value as determined by a Black-Scholes model using the following assumptions: risk-free interest rate, 4.04%; expected life, 5 years; expected volatility 69%. While the warrant is exercisable for up to 2,200,000 shares, Ciphergen and Quest Diagnostics have clarified that the total number of shares of Common Stock issuable upon exercise of the warrant could at no time cause Quest Diagnostics total holdings of Ciphergen s Common Stock to exceed 19.9% of the total number of outstanding shares of Ciphergen Common Stock (provided that Quest Diagnostics may, prior to or concurrently with the exercise of their warrant, sell such number of shares of Ciphergen Common Stock so that, after the exercise of the warrant and such sale of shares, Quest Diagnostics would not own more than 19.9% of Ciphergen s Common Stock). Quest Diagnostics

also agreed to loan Ciphergen up to $10 million with interest accrued at the prime rate plus 0.5% and paid monthly, solely to fund certain development activities related to the strategic alliance. Borrowings may be made by Ciphergen in monthly increments of up to approximately $417,000 on the last day of each month during the first two years of the alliance, and at March 31, 2006, such borrowings amounted to $3.7 million. This loan, collateralized by certain intellectual property of Ciphergen, will be forgiven based on Ciphergen s achievement of certain milestones related to development, regulatory approval and commercialization of certain diagnostic tests. Should the Company fail to achieve these milestones, the outstanding principal amount of any such loans will become due and payable on July 22, 2010. From the inception of the strategic alliance through March 31, 2006, the Company had spent approximately $3.6 million of the loan proceeds on in-house research and development, as well as collaborations with others, directed towards achieving the milestones.

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8. STOCK-BASED COMPENSATION

The Company currently has one equity-based compensation plan, the 2000 Stock Plan (2000 Plan), from which stock-based compensation awards can be granted to eligible employees, officers, directors and other service providers. This plan is administered by, and each award grant must be approved by, the Board of Directors or a committee of the Board, which determines the number of shares and/or options subject to each award, the purchase price for any shares of the Company s common stock subject to an award, the vesting schedule (if any) applicable to each award, the term of each award, and the other terms and conditions of each award, subject to the limitations of the plan. Under the 2000 Plan, options may be granted at prices not lower than 85% and 100% of the fair market value of the common stock for nonstatutory and statutory stock options, respectively. Options generally vest monthly over a period of five years and unexercised options generally expire ten years from the date of grant. The Company issues new shares of common stock upon exercise of stock options. There were 1,775,761 shares available for future stock option grants under the 2000 Plan at March 31, 2006.

The Company also has an employee stock purchase plan, the 2000 Employee Stock Purchase Plan (ESPP). The ESPP is administered by the Board of Directors or a committee of the Board. Subject to limits, all of the Company s officers and employees in the U.S. are eligible to participate in the ESPP. The ESPP generally operates in successive six month offering and purchase periods. Participants in the ESPP may purchase common stock at the end of each six month period at a purchase price equal to 85% of the lower of the fair market value of the stock at the beginning of the six month period or the end of the six month period. The administrator of the ESPP may allow participants to contribute up to 15% of their eligible compensation to purchase stock under the plan. At March 31, 2006, the Company had 336,498 shares of common stock reserved for purchase by employees under the ESPP.

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised), Share-Based Payment (SFAS 123(R)), using the modified prospective transition method. Under this new standard, the Company s estimate of compensation expense requires a number of complex and subjective assumptions, including the price volatility of Ciphergen s common stock, employee exercise patterns (expected life of the options), future forfeitures and related tax effects. Prior to the adoption of SFAS 123(R), the Company accounted for stock option grants using the intrinsic value method, in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and accordingly, recognized no compensation expense for stock option grants.

Under the modified prospective approach, SFAS 123(R) applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized in the first quarter of 2006 includes compensation cost for all stock-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and compensation cost for all stock-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Prior periods were not restated to reflect the impact of adopting the new standard.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company s net loss and basic and diluted net loss per share for the three months ended March 31, 2006 were $460,000 and $0.01 higher, respectively, than if the Company had continued to account for stock-based compensation under APB 25 for its stock option grants. The Company has a 100% valuation allowance recorded against its deferred tax assets. Therefore SFAS 123(R) had no effect on the income tax provision in the consolidated statement of operations or the consolidated statement of cash flows.

Prior to 2006, the Company accounted for its stock-based employee compensation arrangements using the intrinsic value method of accounting. Unearned compensation expense was based on the difference, if any, on the date of the grant between the fair value of the Company s stock and the exercise price. Unearned compensation was amortized and expensed using an accelerated method. The Company accounted for stock issued to non-employees using the fair value method of accounting. The following table illustrates the effect on the Company s net loss and net loss per share had compensation expense for stock-based compensation been determined in accordance with SFAS 123 for the three months ended March 31, 2005 (in thousands, except per share amounts):

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Net loss as reported	$ (9,332)
Add: Employee stock-based compensation expense in reported net loss, net of tax	
Less: Employee stock-based compensation expense determined under the fair value method, net of tax	(1,063)
Pro forma net loss	$ (10,395)
Basic and diluted net loss per share:	
As reported	$ (0.32)
Pro forma	$ (0.35)

The Company used the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the following weighted-average assumptions for the indicated periods.

	Stock Option Plan Three Months Ended March 31,		Employee Stock Purchase Plan Three Months Ended March 31,	
	2006	2005	2006	2005
Assumptions:				
Risk-free interest rate	4.85%	3.73%	4.81%	3.13%
Expected term (in years)	6.1	5.0	0.5	0.5
Expected volatility	88%	64%	92%	64%
Expected dividend yield	%	%	%	%
Weighted-average grant-date fair values:				
Exercise price less than market price	$	$	$ 1.34	$ 0.93
Exercise price equal to market price	1.12	1.67		
Exercise price greater than market price				

The expected term of stock options represents the weighted-average period the stock options are expected to remain outstanding. Prior to January 1, 2006, the expected term was developed based on observed and expected time to post-vesting exercise or forfeiture of an option. After January 1, 2006, the expected term of options granted was derived using the simplified method allowed by SAB 107. Prior to January 1, 2006, expected volatility was derived exclusively from an analysis of the Company s historical stock prices. After January 1, 2006, expected volatility was derived from the Company s historical stock prices and peer group analysis. The risk-free interest rate is based on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. The expected dividend assumption is based on the Company s history and expectation of dividend payouts.

The Company recognizes stock-based compensation costs for grants made after January 1, 2006 on a straight-line basis over the requisite service period of the award, which is generally the option vesting term. These costs should reflect awards ultimately expected to vest, and have therefore been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to January 1, 2006, the Company accounted for forfeitures as they occurred. Stock-based compensation costs for grants made prior to January 1, 2006 are recognized on an accelerated basis over the option vesting term, generally five years, consistent with prior years footnote presentations under SFAS 123.

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The following table represents stock option activity for the three months ended March 31, 2006 (numbers of shares stated in thousands):

	Total Options Outstanding		
	Number of Shares	Weighted -Average Exercise Price	Weighted-Average Remaining Contract Life (Years)
Outstanding options at beginning of period	6,334	$ 4.46	7.7
Granted	26	1.50	
Exercised			
Forfeited	(305)	5.08	
Outstanding options at end of period	6,055	$ 4.42	7.5
Outstanding options exercisable at end of period	4,170	$ 5.54	6.7

At March 31, 2006, the aggregate intrinsic value of options outstanding was $525,000 and the aggregate intrinsic value of outstanding options exercisable was $101,000. Also, there was $1.4 million of unrecognized compensation cost related to stock option grants to employees which is expected to be recognized over a weighted average period of 1.1 years.

The allocation of stock-based compensation expense by functional area for the three months ended March 31, 2006 was as follows (in thousands):

Cost of products revenue	$ 45
Research and development	100
Sales and marketing	103
General and administrative	212
Total	$ 460

9. INCOME TAXES

Based on the available objective evidence, management believes it is more likely than not that the net deferred tax assets related to the Company s operations will not be fully realizable. Accordingly, the Company has provided a full valuation allowance against its net deferred tax assets at March 31, 2006. The Company incurs income tax liabilities in most of the countries outside the U.S. in which it operates.

10. COMPREHENSIVE LOSS

Comprehensive income (loss) generally represents all changes in stockholders equity except those resulting from investments or contributions by stockholders. The only component of comprehensive income (loss) that is excluded from the net loss during the periods presented is the Company s cumulative translation adjustments.

11. NET LOSS PER SHARE

Basic net loss per share is calculated using the weighted average number of common shares outstanding during the period. Because the Company is in a net loss position, diluted earnings per share is calculated using the weighted average number of common shares outstanding and excludes the effects of 11.6 million and 8.8 million potential common shares as of March 31, 2006 and 2005, respectively, that are antidilutive. Potential common shares include shares that could be issued if all convertible senior notes were converted into common stock, shares of common stock issuable upon the exercise of an outstanding warrant held by Quest Diagnostics, common stock subject to repurchase, common stock issuable under the Company s 2000 Employee Stock Purchase Plan, and shares of common stock

potentially issuable upon the exercise of outstanding stock options.

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12. SEGMENT INFORMATION AND GEOGRAPHIC DATA

Ciphergen s revenue is derived from the sales of related products and services on a worldwide basis. The chief operating decision maker evaluates resource allocation not on a product or geographic basis, but rather on an enterprise-wide basis. Therefore, management has determined that Ciphergen operates in only one reportable segment, which is the protein research tools and collaborative services business.

The Company sells most of its products and services directly to customers in North America, Western Europe and Japan, and through distributors in other parts of Europe and Asia and in Australia. Revenue for geographic regions reported below is based upon the customers locations. Following is a summary of the geographic information related to revenue for the three month periods ended March 31, 2006 and 2005 (in thousands):

	Three Months Ended March 31,	
	2006	2005
Revenue		
United States	$ 1,818	$ 3,330
Canada	397	333
Europe	2,695	1,517
Asia-Pacific	2,154	1,468
Total	$ 7,064	$ 6,648

During the three month periods ended March 31, 2006 and 2005, sales to customers in Japan represented 27% and 21% of revenue, respectively. No other country outside the U.S. accounted for 10% or more of total revenue during these periods.

Long-lived assets, primarily machinery and equipment, are reported based on the location of the assets. Long-lived asset information by geographic area as of March 31, 2006 and December 31, 2005 is presented in the following table (in thousands):

	March 31, 2006	December 31, 2005
Long lived assets		
United States	$ 5,820	$ 6,256
Canada	10	20
Europe	427	561
Asia-Pacific	498	483
Total	$ 6,755	$ 7,320

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

We have made statements under the captions Management s Discussion and Analysis of Financial Condition and Results of Operations , Factors That May Affect Our Results and in other sections of this Form 10-Q that are forward-looking statements for purposes of the safe harbor provisions under the Private Securities Litigation Reform Act of 1995. We claim the protection of such safe harbor, and disclaim any intent or obligation to update any forward-looking statement. You can identify these statements by forward-looking words such as may , will , expect , intend , anticipate , believe , estimate , plan , could , should and continue or similar words. These forward-l statements may also use different phrases. We have based these forward-looking statements on our current expectations and projections about future events. Examples of forward-looking statements include statements about

projections of our future revenue, gross margin, expenses, losses, results of operations and financial condition; anticipated deployment, capabilities and uses of our products and our product development activities and product innovations; the importance of proteomics as a major focus of biology research; the ability of our products to enable proteomics research; competition and competitive pricing pressure in the markets in which we compete; existing and future collaborations and partnerships; our ability to operate our Biomarker Discovery Center® laboratories and secure the commercial rights to biomarkers discovered at our Biomarker Discovery Center laboratories; the utility of biomarker discoveries and the effectiveness of our Biomarker Discovery Center laboratories; our plans to develop and commercialize diagnostic tests through our strategic alliance with Quest Diagnostics; our ability to comply with applicable government regulations; our ability to expand and protect our intellectual property portfolio; our ability to decrease research and development costs; our ability to decrease sales and marketing costs; our ability to decrease general and administrative costs; expected stock-based compensation costs following our adoption of Statement of Financial Accounting Standards No. 123 (Revised), Share-Based Payment , (SFAS 123(R)); anticipated future losses; expected levels of capital

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expenditures; our ability to meet development milestones in order to achieve the forgiveness of loan obligations to Quest Diagnostics; the rating of our convertible notes and the value of the related put options; the period of time for which our existing financial resources, debt facilities and interest income will be sufficient to enable us to maintain current and planned operations; foreign currency exchange rate fluctuations and our plans for mitigating foreign currency exchange risks; and the market risk of our investments. These statements are subject to risks and uncertainties that could cause actual results to differ materially, including the risks set forth under the caption Risk Factors in this Form 10-Q and the similar factors and risks outlined in our other filings with the Securities and Exchange Commission (SEC).

OVERVIEW

Ciphergen is dedicated to translating protein biomarkers and panels of biomarkers into protein molecular diagnostic tests that improve patient care. We are also focused on providing collaborative research services through our Biomarker Discovery Center laboratories for biomarker discovery for new diagnostic tests as well as pharmacoproteomic services for improved drug toxicology, efficacy and theranostic assays. We develop, manufacture and sell our family of ProteinChipâ Systems, which use patented Surface Enhanced Laser Desorption/Ionization (SELDI) technology. ProteinChip Systems enable protein discovery, validation, identification and assay development to provide researchers with predictive, multi-marker assay capabilities and a better understanding of biological function at the protein level. These systems consist of a ProteinChip Reader, ProteinChip Software and related accessories which are used in conjunction with our consumable ProteinChip Arrays. We also offer consulting services, customer support services and training classes to further our customers success in using SELDI technology. We market and sell our products primarily to research biologists in pharmaceutical and biotechnology companies, and academic and government research laboratories.

Through a series of acquisitions and license agreements executed in 1997, 1998 and 2003, we acquired an exclusive, worldwide license and right to sublicense the SELDI technology and to commercialize any and all products, information and services derived from the technology without limitation. Our first designed and manufactured system, the ProteinChip System, Series PBS I, was available for shipment in the third quarter of 1997. In 1997, we also established a subsidiary in the U.K. and began direct selling in Europe. During 1999, we initiated an expanded marketing program and in May 1999 began shipping the ProteinChip System, Series PBS II, the latest version of which is now referred to as the ProteinChip Biology System. In 1999, we also established a joint venture with Sumitomo Corporation to distribute our products in Japan. During 2000, we began offering research services and established Biomarker Discovery Center laboratories in Fremont, California; Copenhagen, Denmark; and Malvern, Pennsylvania.

In 2001, we introduced the ProteinChip Biomarker System, which utilizes sophisticated third-party software to automate pattern recognition-based statistical analysis methods and correlate protein expression patterns from clinical samples with disease phenotypes. We also began selling the Biomek® 2000 Workstation, later superseded by the Biomek 3000 workstation, a robotic accessory which is manufactured by Beckman Coulter and which has been optimized for use with our ProteinChip Biomarker System to increase sample throughput and reproducibility. In addition, we expanded our product offering with a SELDI ProteinChip interface to high-end tandem mass spectrometers. On July 31, 2001, Ciphergen acquired the BioSepraâ process chromatography business from Invitrogen Corporation; this business was subsequently sold to Pall Corporation on November 30, 2004.

On August 31, 2002, we increased our ownership interest in Ciphergen Biosystems KK, the Japanese joint venture we formed with Sumitomo Corporation in 1999, from 30% to 70%. Shortly thereafter, we opened a Biomarker Discovery Center laboratory at the Yokohama facility of Ciphergen Biosystems KK. In October 2002, we launched the ProteinChip AutoBiomarker System, an automated version of our ProteinChip Biomarker System, which incorporates an autoloader and a Biomek robot to increase sample throughput and automate the reading of ProteinChip Arrays. On March 23, 2004, we purchased the remaining 30% ownership interest in Ciphergen Biosystems KK. In July 2004, we launched the ProteinChip System, Series 4000, our next generation ProteinChip System.

We have used our resources primarily to develop and improve our proprietary ProteinChip Systems and related consumables and to establish a marketing and sales organization for commercialization of our products. We have also

used our funds to establish a joint venture to distribute our products in Japan and to increase our ownership in the joint venture to 100%. In addition, we acquired the BioSepra process chromatography business in 2001, which we sold for a gain in 2004. We have also used our resources to establish Biomarker Discovery Center laboratories to provide research services to our clients, to foster further adoption of our products and technology, and to discover biomarkers that we seek to patent for diagnostic and other purposes. In early 2004, we increased our efforts to discover and commercialize protein biomarkers and panels of biomarkers that we expect can be developed into protein molecular diagnostic tests that improve patient care; to date, these efforts have not generated commercialized products or any revenue from diagnostic tests. Since our inception we have incurred significant losses and as of March 31, 2006, we had an accumulated deficit of $201.3 million.

Our sales are currently driven by the need for new and better tools to perform protein discovery, characterization, purification, identification and assay development. Many of the ProteinChip Systems sold to our customers also generate a recurring revenue stream from the sale of consumables and maintenance contracts. In addition, some of our customers later enhance their ProteinChip Systems by adding our automation accessories and advanced software.

Our expenses have consisted primarily of materials, contracted manufacturing services, labor and overhead costs to manufacture our ProteinChip Systems and ProteinChip Arrays and to provide customer services; marketing and sales

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activities; research and development programs; litigation; and general and administrative costs associated with our operations. We expect to incur losses for at least the next year. Our current level of revenue is insufficient for us to become profitable. To become profitable, we will need to increase sales of our ProteinChip Systems, Arrays and collaborative services into the research and development market as well as begin achieving revenue from our diagnostic efforts.

We anticipate that our quarterly results of operations will fluctuate for the foreseeable future due to several factors, including market acceptance of current and new products and services, the length of the sales cycle and timing of significant orders, the timing and results of our research and development efforts, the introduction of new products by our competitors and possible patent or license issues. Our limited operating history makes accurate prediction of future results of operations difficult.

RECENT DEVELOPMENTS

On December 5, 2005, a securities class action suit was filed against Ciphergen Biosystems, Inc. (Ciphergen or the Company) and certain former officers and directors. The complaint was captioned *Cohen v. Ciphergen Biosystems, Inc., et al.* (Docket No. C-05-4997-MHP) and was filed in the United States District Court for the Northern District of California. The lawsuit was filed on behalf of the purchasers of the Company s common stock between August 8, 2005 and November 16, 2005. Plaintiff alleged, among other things, violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified monetary damages and other relief against all defendants. On March 28, 2006, the parties stipulated to the dismissal of the action without prejudice. The Court ordered the action dismissed per the parties stipulation on March 29, 2006.

RESULTS OF OPERATIONS

Effective January 1, 2006, we adopted SFAS 123(R) using the modified prospective transition method. As a result, compensation costs in the first quarter of 2006 include compensation cost for all stock-based payments granted prior to, but not yet vested as of, January 1, 2006, as well as compensation cost for all stock-based payments granted during the first quarter of 2006. Prior periods were not restated to reflect the impact of adopting the new standard.

COMPARISON OF THE THREE MONTH PERIODS ENDED MARCH 31, 2006 AND MARCH 31, 2005

PRODUCTS REVENUE. Products revenue increased to $4.8 million in the first quarter of 2006 from $4.5 million in the same period of 2005, an increase of $328,000 or 7%. The increase was primarily the result of an $831,000 or 40% increase in revenue from sales of our ProteinChip Systems, accessories and software, partly offset by a $503,000 or 21% decline in revenue from arrays and consumables. The increase in revenue from sales of our ProteinChip Systems, accessories and software was largely due to a 13% increase in unit sales of ProteinChip Systems, as well as an increase in average revenue per system of approximately 24% due to less discounting comparing the first quarter of 2006 to the same period in 2005.

SERVICES REVENUE. Services revenue increased to $2.3 million in the first quarter of 2006 from $2.2 million in the same period of 2005, an increase of $88,000 or 4%. This increase was primarily due to an increase of approximately $467,000 in revenue from Biomarker Discovery Center projects due to completion of several large contracts in the first quarter of 2006. This increase was partly offset by a decrease in revenue from training and consulting services of approximately $235,000, which we believe was due to the reduction in the number of field scientists on our staff, and a decrease in revenue from our maintenance contracts of $144,000 due to having fewer instruments under contract.

We expect that future revenues for our business will be affected by, among other things, our ability to develop and commercialize diagnostic tests based on the ProteinChip platform, demand for our ProteinChip Systems and Arrays, the degree of acceptance by the market of our Series 4000 platform, the level of continuing purchases of arrays by existing customers, new product and application introductions, customer budgets, competitive conditions and government funding for research in our field.

COST OF PRODUCTS REVENUE. Cost of products revenue increased to $2.3 million in the first quarter of 2006 from $2.1 million in the same period of 2005, an increase of $161,000 or 8%. The gross margin for products revenue was 53% in both the first quarter of 2006 and the first quarter of 2005. The gross margin improved in the first quarter of 2006 compared to the same period in 2005 partly as a result of an increase in the average selling price of our ProteinChip Systems, resulting in an increase in gross margin of approximately 6% of products revenue. Reduced

provisions for excess and obsolete inventories also improved the gross margin by approximately 5% of products revenue, and reduced scrap and inventory shrinkage improved the gross margin by approximately 3% of products revenue. However, the gross margin comparison was also affected by the sale in last year s first quarter of some Series 4000 systems built with components previously charged to research and development expense prior to the product achieving technological feasibility. This resulted in a decrease in the gross margin of approximately 8% of product revenue comparing the first quarter of 2006 to the same period in 2005. In addition, our gross margin declined due to higher absorption variances resulting primarily from unused capacity in consumables manufacturing. Stock-based compensation expense included in cost of products revenue was $45,000 in the first quarter of 2006.

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COST OF SERVICES REVENUE. Cost of services revenue increased to $1.1 million in the first quarter of 2006 from $1.0 million in the same period of 2005, an increase of $108,000 or 11%. The largest component of this increase came from Biomarker Discovery Center contracts, whose costs typically vary based on the complexity and difficulty of the work being undertaken. The gross margin for services revenue decreased to 50% in the first quarter of 2006 compared to 53% in the same period of 2005. This decrease was mainly due to one consulting project we undertook in Europe for strategic reasons which has a very low profit margin.

We believe that gross profit as a percentage of revenue in future periods will be particularly affected by our sales volumes, competitive pricing pressure and provisions for inventory reserves.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses decreased to $3.0 million in the first quarter of 2006 from $3.5 million in the same period of 2005, a decrease of $515,000 or 15%. The decrease was largely due to a 38% decrease in headcount comparing March 31, 2006 to March 31, 2005, resulting in a decrease in payroll and related costs of approximately $744,000. Cancelling or scaling back selected early-stage research and development projects related to new instrumentation platforms as part of our efforts to control expenses resulted in a decrease of $118,000 for materials and supplies used in new product development. These decreases were partly offset by an increase in collaboration costs of $265,000, largely due to our collaboration with University College London, which began in October 2005. Stock-based compensation expense included in research and development expenses was $100,000 in the first quarter of 2006.

We expect research and development expenses to decline in 2006 relative to 2005 due to having fewer research and development employees in 2006 as well as slowing or canceling selected early-stage research and development programs related to new instrumentation platforms as part of our efforts to control expenses, partially offset by an increase in our research and development activities associated with developing and commercializing diagnostic tests as part of our strategic alliance with Quest Diagnostics, and discovering biomarkers that could potentially be developed into additional diagnostic products. The decline in research and development expenses will also be partly offset by stock-based compensation expense.

SALES AND MARKETING EXPENSES. Sales and marketing expenses decreased to $3.5 million in the first quarter of 2006 from $5.3 million in the same period of 2005, a decrease of $1.8 million or 34%. The decrease was largely due to a 25% decrease in headcount comparing March 31, 2006 to March 31, 2005, resulting in a decrease in payroll and related costs of approximately $945,000. This also resulted in reductions in travel and other operating expenses in sales and marketing of approximately $227,000. Internal consumption of ProteinChip Arrays and other consumables for customer demonstrations and support decreased approximately $245,000. Equipment costs, consisting primarily of depreciation on demonstration ProteinChip Systems, declined approximately $220,000, as we have fewer demonstration systems in service. Costs for trade shows, advertising and other marketing activities declined approximately $131,000. Stock-based compensation expense included in sales and marketing expenses was $103,000 in the first quarter of 2006.

We expect sales and marketing expenses to decrease in 2006 relative to 2005 as a result of a smaller sales force and reduced associated selling expenses. The decline in sales and marketing expenses will be partly offset by stock-based compensation expense.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses decreased to $2.3 million in the first quarter of 2006 from $3.5 million in the same period of 2005, a decrease of $1.2 million or 35%. The decrease was largely due to a 37% reduction in headcount comparing March 31, 2006 to March 31, 2005, resulting in a decrease in payroll and related costs of approximately $681,000. This decrease was accompanied by decreases of $365,000 in audit and accounting fees, $179,000 in legal fees primarily related to patent activities, and $153,000 in consulting and outside services. Stock-based compensation expense included in general and administrative expenses was $212,000 in the first quarter of 2006.

We expect general and administrative expenses to decrease in 2006 relative to 2005 due to lower headcount in administrative functions and because certain large expenses incurred in 2005, such as severance payments to former executives and outside professional fees related to the restatement of our financial results for the second quarter of 2005, are not expected to recur. In addition, we expect our costs related to compliance with Section 404 of the Sarbanes-Oxley Act of 2002 to decrease significantly as we are now deemed to be a non-accelerated filer and thus not

subject to the full requirements of Section 404. However, these reductions are expected to be partly offset by stock-based compensation expense.

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INTEREST AND OTHER INCOME (EXPENSE), NET. Interest income in the first quarter of 2006 was $238,000 compared to $182,000 in the same period of 2005. Interest income increased due to higher interest rates in the first quarter of 2006 compared to the same period in 2005. Interest expense in the first quarter of 2006 was $533,000 compared to $492,000 in the same period of 2005. Interest expense in both periods consisted largely of interest accrued for our convertible senior notes, borrowings from Quest Diagnostics, equipment-financing loan and capital leases. Approximately $132,000 of the interest expense in the first quarters of 2006 and 2005 was non-cash, attributable to amortization of the beneficial conversion feature associated with the convertible senior notes. Other income (expense) in the first quarter of 2006 was net income of $59,000 compared to a net expense of $101,000 in the same period of 2005. The net income in the first quarter of 2006 resulted primarily from $160,000 received in settlement of a claim against a service provider, partly offset by $93,000 for amortization of the offering costs related to the convertible senior notes. The net expense in the first quarter of 2005 resulted largely from the amortization of the offering costs related to the convertible senior notes.

INCOME TAX PROVISION (BENEFIT). The provision for income taxes in the first quarter of 2006 was $114,000 compared to $150,000 in the same period of 2005. The decrease in expense was primarily due to lower income projected for our Japanese subsidiary, Ciphergen Biosystems KK, in 2006.

LIQUIDITY AND CAPITAL RESOURCES

From our inception through March 31, 2006, we have financed our operations principally with $218.1 million from the sales of products and services to customers and net proceeds from equity financings totaling approximately $160.8 million, including $15.0 million from the sale to Quest Diagnostics on July 22, 2005 of 6,225,000 shares of Ciphergen s common stock and a warrant to purchase up to 2,200,000 shares of Ciphergen s common stock. We received $28.1 million of net proceeds from the sale of 4.5% convertible senior notes on August 22, 2003. These notes are due September 1, 2008. In addition, in July 2005 Quest Diagnostics agreed to loan us up to $10 million with interest accrued at the prime rate plus 0.5% and paid monthly, solely to fund certain development activities related to our strategic alliance, against which we had borrowed approximately $3.7 million as of March 31, 2006. We also received net proceeds of $28.0 million from the sale of our BioSepra business in November 2004. Cash, cash equivalents and a short-term investment at March 31, 2006 were $24.4 million, compared to $28.0 million at December 31, 2005. Working capital at March 31, 2006 was $24.3 million, compared to $27.1 million at December 31, 2005. The decrease in working capital was principally due to a net $3.6 million decrease in cash and short-term investments to fund our operating losses, a $758,000 decrease in accounts receivable, and a $588,000 decrease in inventory, partly offset by a $2.0 million decrease in payables and accrued liabilities. Long-term debt and capital lease balances at March 31, 2006 totaled $32.7 million compared to $31.5 million at December 31, 2005.

Net cash used in operating activities was $4.1 million in the first three months of 2006 compared to $4.0 million in the same period of 2005. Reductions in payroll expense of $2.1 million, other operating and manufacturing overhead expenditures of $1.8 million and raw materials inventory purchases of $923,000, comparing the first three months of 2006 to the same period of 2005, were offset by approximately $4.9 million less in collections from customers in the first three months of 2006 than in the comparable period of 2005.

Net cash provided by investing activities was $1.7 million in the first three months of 2006 compared to net cash used in investing activities of $1.1 million in the first three months of 2005. Net cash provided by investing activities in the first three months of 2006 consisted of $2.2 million from the liquidation of an investment in a fixed rate annuity, partly offset by net purchases of property and equipment of approximately $455,000 and payments totaling $136,000 for a technology license related to our litigation which was settled in 2003. Net cash used in investing activities in the first three months of 2005 consisted of net purchases of property and equipment of approximately $944,000, and payments totaling $174,000 for a technology license related to our litigation which was settled in 2003. We anticipate capital expenditures of approximately $2 million in 2006.

Net cash provided by financing activities was $1.1 million in the first three months of 2006 compared to $10,000 in the first three months of 2005. Net cash provided by financing activities in the first three months of 2006 consisted of $1.3 million in loans from Quest Diagnostics, partly offset by $186,000 for repayments of an equipment financing loan. Net cash provided by financing activities in the first three months of 2005 was derived primarily from the repayment of stockholder loans in the aggregate principal amount of $310,000, largely offset by repayments of an

equipment financing loan of $300,000.

We believe that current cash resources will be sufficient to maintain our operations at least for the next 12 months. We currently expect to fund our liquidity needs as well as expenditures for our obligations related to the strategic alliance

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with Quest Diagnostics and for capital requirements from a combination of available cash, borrowings from Quest Diagnostics, and potential sales of assets and additional equity and/or debt securities. We will be required to raise additional capital at some point in the future, which might be achieved through a variety of sources, including the public equity market, private financings, sales of assets, collaborative arrangements and debt. If additional capital is raised through the issuance of equity or securities convertible into equity, our stockholders may experience dilution, and such securities may have rights, preferences or privileges senior to those of the holders of our common stock or the notes. If we obtain additional funds through arrangements with collaborators or strategic partners, we may be required to relinquish our rights to certain technologies or products that we might otherwise seek to retain. Additional financing may not be available to us on favorable terms, if at all. If we are unable to obtain financing on acceptable terms, we may be unable to execute our business plan and we could be required to delay, reduce the scope of, or eliminate our operations and we may not be able to pay off the convertible senior notes or the loans from Quest Diagnostics if and when they come due.

The following summarizes Ciphergen s contractual cash obligations at March 31, 2006 and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands, except the footnotes).

	Total	Less than 1 Year	1-3 Years	4-5 Years	Beyond 5 Years
Contractual cash obligations:					
Capital lease obligations (1)	$ 44	$ 22	$ 22	$	$
Interest payable on capital lease obligations	2	2			
Equipment financing loan (1)	190	190			
Interest payable on equipment financing loan	2	2			
Loan from Quest Diagnostics (1)	3,750			3,750	
Interest payable on loan from Quest Diagnostics (2)	1,359	309	619	431	
Convertible senior notes (3)	30,000		30,000		
Interest payable on convertible senior notes	3,375	1,350	2,025		
Non-cancelable collaboration obligation (4)	1,100	1,100			
Non-cancelable operating lease obligations	9,931	4,095	5,412	424	
Purchase obligations (5)	522	522			
Total contractual cash obligations	$ 50,275	$ 7,592	$ 38,078	$ 4,605	$

(1) Principal amounts, not including interest.

(2) Based on outstanding

principal balance and interest rate as of March 31, 2006.

(3) Excludes the beneficial conversion feature amounting to $2,677,000, less related amortization of $1,395,000.

(4) On October 3, 2005, the Company entered into a two year research and license agreement with University College London and UCL BioMedica Plc. (together, UCL) to utilize Ciphergen s suite of proteomic solutions (Deep Proteome , Pattern Track Process and ProteinChip System) to further UCL s ongoing research in ovarian cancer and breast cancer. Under the terms of the agreement, Ciphergen will have exclusive rights to license intellectual property

resulting from discoveries made during the course of this collaboration for use in developing, manufacturing and selling products and services utilizing the intellectual property. Ciphergen is obligated to make contributions of approximately $2.1 million in cash and $652,000 in the form of Ciphergen equipment, software, arrays and consumable supplies as requested by UCL, valued at Ciphergen s list selling price, to cover part of the costs incurred by UCL specifically for this research program. $1.1 million of the cash obligation is to be paid in the first year of the agreement and is non-cancelable. The remainder is to be paid in the second year of the agreement and

is cancelable with three months advance notice. As of March 31, 2006, Ciphergen had expensed $583,000, of which $50,000 represented our cost for the arrays and consumables we had provided, and the remaining $533,000 was recorded as an accrued liability.

(5) Purchase obligations include agreements to purchase inventory that are enforceable and legally binding on Ciphergen

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and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase obligations exclude agreements that are cancelable without penalty.

Ciphergen believes it has complied with all requirements set forth in its credit agreements.

RECENT ACCOUNTING PRONOUNCEMENTS

See note 2 of the Unaudited Condensed Consolidated Financial Statements for a description of recent accounting pronouncements, including the respective dates of adoption and effects on results of operations and financial condition.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have classified our short-term investments as available-for-sale, and have accordingly recorded them on the balance sheet at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income (loss). These investments are not leveraged and are held for purposes other than trading.

The following discussion about our market risk involves forward-looking statements. We are exposed to market risk related mainly to changes in interest rates. We do not invest in derivative financial instruments.

INTEREST RATE SENSITIVITY

As of March 31, 2006, our cash was held primarily in money market accounts. We believe that, in the near-term, we will maintain our available funds in money market accounts.

The primary objective of our investment activities is to preserve principal, maintain proper liquidity to meet operating needs and maximize yields. Our investment policy, which has been approved by our Board of Directors, specifies credit quality standards for our investments and limits the amount of credit exposure to any single issue, issuer or type of investment.

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our available funds for investment. Our long-term debt and capital lease agreements are at fixed interest rates. We do not plan to use derivative financial instruments in our investment portfolio.

FOREIGN CURRENCY EXCHANGE RISK

Most of our revenue is realized in U.S. dollars. However, all our revenue in Japan is realized in Japanese yen. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Because most of our revenue is currently denominated in U.S. dollars, an increase in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in foreign markets.

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The functional currency of Ciphergen Biosystems KK is the Japanese yen. Accordingly, the accounts of this operation are translated from yen to the U.S. dollar using the current exchange rate in effect at the balance sheet date for the balance sheet accounts, and using the average exchange rate during the period for revenue and expense accounts. The effects of translation are recorded as a separate component of stockholders equity.

The accounts of all other non-U.S. operations are remeasured to the U.S. dollar, which is the functional currency. Accordingly, all monetary assets and liabilities of these foreign operations are translated into U.S. dollars at current period-end exchange rates, and non-monetary assets and related elements of expense are translated using historical rates of exchange. Income and expense elements are translated to U.S. dollars using average exchange rates in effect during the period. Gains and losses from the foreign currency transactions of these subsidiaries are recorded as other income (expense), net in the statement of operations.

The net tangible assets of our non-U.S. operations, excluding intercompany debt, were $4.8 million at March 31, 2006.

We did not enter into any forward contracts during the three month periods ended March 31, 2005 and 2006. Although we will continue to monitor our exposure to currency fluctuations, we cannot provide assurance that exchange rate fluctuations will not harm our business in the future.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) designed to ensure that information required to be disclosed in our filings under the Exchange Act is recorded, processed, summarized and reported accurately and within the time periods specified in the SEC s rules and forms. As of March 31, 2006, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2006, the design and operation of these disclosure controls and procedures were effective to provide reasonable assurance of the achievement of the objectives described above.

Changes in Internal Control Over Financial Reporting

During the quarter ended March 31, 2006, there were no changes in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On December 5, 2005, a securities class action suit was filed against Ciphergen Biosystems, Inc. (Ciphergen or the Company) and certain former officers and directors. The complaint was captioned *Cohen v. Ciphergen Biosystems, Inc., et al.* (Docket No. C-05-4997-MHP) and was filed in the United States District Court for the Northern District of California. The lawsuit was filed on behalf of the purchasers of the Company s common stock between August 8, 2005 and November 16, 2005. Plaintiff alleged, among other things, violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified monetary damages and other relief against all defendants. On March 28, 2006, the parties stipulated to the dismissal of the action without prejudice. The Court ordered the action dismissed per the parties stipulation on March 29, 2006.

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ITEM 1A. RISK FACTORS

The reader should carefully consider each of the risks and uncertainties we describe below, as well as all of the other information in this report. The risks and uncertainties we describe below are not the only ones we face. Additional risks and uncertainties which we are currently unaware of or that we currently believe to be immaterial could also adversely affect our business.

We expect to continue to incur net losses in 2006 and 2007. If we are unable to significantly increase our revenues or significantly decrease our expenses, we may never achieve profitability.

From our inception in December 1993 through March 31, 2006, we have generated cumulative revenue from continuing operations of approximately $182.2 million and have incurred net losses of approximately $201.3 million. We have experienced significant operating losses each year since our inception and expect these losses to continue for at least the next several quarters. For example, we experienced net losses of approximately $25.8 million in 2001, $29.1 million in 2002, $36.7 million in 2003, $19.8 million in 2004, $35.4 million in 2005 and $5.5 million in the first quarter of 2006. Our losses have resulted principally from costs incurred in research and development, sales and marketing, litigation, and general and administrative costs associated with our operations. These costs have exceeded our gross profit which, to date, has been generated principally from product sales. We expect to incur additional operating losses and these losses may be substantial. We may never achieve profitability. Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis.

If we are unable to further establish the utility of our products, our products and services may not achieve market acceptance.

The commercial success of our ProteinChip Systems and Arrays depends upon validating their utility for important biological applications and increasing their market acceptance by researchers in pharmaceutical and biotechnology companies, academic and government research centers and clinical reference laboratories. If our products are not demonstrated to be more effective in providing commercially useful protein information than other existing technologies, or if we are unable to develop diagnostic tests using our ProteinChip technology, it could seriously undermine market acceptance of our products and reduce the likelihood that we will ever achieve profitability.

If we fail to successfully market the Series 4000, expand sales of our ProteinChip Systems, and develop new and improved applications for our products, our revenue will not increase and we will not achieve profitability.

Our success depends on our ability to expand commercial sales of our ProteinChip Systems and Arrays, and develop new and improved applications for this platform. In particular, our success will depend on our success in marketing and growing sales of our ProteinChip System, Series 4000. If the performance of our system does not meet or exceed competitive offerings, it is unlikely that we will be able to expand our sales. We may encounter difficulties in developing new, higher performance products or producing our current proteomic systems on a timely basis, we may not be able to produce them economically, we may fail to achieve expected performance levels, or we may fail to gain industry acceptance of such products.

We may experience increased manufacturing costs or failure rates for our ProteinChip Systems and Arrays that are higher than we anticipated, particularly for new products that are introduced.

Our products and the components used in our products are based on complex technologies and we are currently in the process of developing new versions of certain products. We may not be able to cost effectively manufacture such new products. In addition, it is difficult to predict the failure rate of new products. If our manufacturing costs are higher than anticipated or if the failure rates for our products are higher than anticipated, resulting in increased warranty claims and increased costs associated with servicing those claims, our gross profit will decrease.

We may not succeed in developing diagnostic products and even if we do succeed in developing diagnostic products, they may never achieve significant commercial market acceptance.

There is considerable risk in developing diagnostic products based on our biomarker discovery efforts as potential tests may fail to validate results in larger clinical studies and may not achieve acceptable levels of clinical sensitivity and specificity. If we do succeed in developing diagnostic tests with acceptable performance characteristics, we may not succeed in achieving significant commercial market acceptance for those tests. Our ability to successfully commercialize diagnostic products that we may develop, such as tests, kits and devices, will depend on several factors, including:

our ability to convince the medical community of the safety and clinical efficacy of our products and their advantages over existing diagnostic products;

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our ability to further establish business relationships with other diagnostic companies that can assist in the commercialization of these products; and

the agreement by Medicare and third-party payers to provide full or partial reimbursement coverage for our products, the scope and extent of which will affect patients willingness to pay for our products and will likely heavily influence physicians decisions to recommend our products.

These factors present obstacles to significant commercial acceptance of our potential diagnostic products, which we will have to spend substantial time and money to overcome, if we can do so at all. Our inability to successfully do so would prevent us from generating additional revenue from diagnostic products and we could be unable to develop a profitable business.

Our ability to commercialize our potential diagnostic tests is heavily dependent on our strategic alliance with Quest Diagnostics.

On July 22, 2005, Ciphergen and Quest Diagnostics entered into a strategic alliance which will focus on commercializing up to three assays chosen from Ciphergen s pipeline over the next three years. If this strategic alliance does not continue for its full term or if Quest Diagnostics fails to proceed to diligently perform its obligations as part of the strategic alliance, such as independently developing, validating and commercializing potential diagnostics tests, our ability to commercialize our potential diagnostic tests would be seriously harmed. If we elect to increase our expenditures to fund diagnostic development programs or research programs on our own, we will need to obtain additional capital, which may not be available on acceptable terms, or at all. If we fail to develop diagnostic tests, our ability to expand our business beyond the sale of ProteinChip Systems and Arrays would be seriously harmed.

If we are unable to attract additional clients for our Biomarker Discovery Center services and satisfy these clients, we may not be successful in furthering adoption of our products and technology or generating additional revenue through commercial rights related to biomarker discoveries.

One element of our business strategy is to operate Biomarker Discovery Center laboratories in part through partnerships with pharmaceutical and biotechnology companies as well as academic and government research centers in order to increase adoption of our products and technology. Although we are currently in negotiation with additional potential partners and clients, to date we have entered into only a few such arrangements. Failure to enter into additional arrangements or expand existing relationships could limit adoption of our products and prevent us from generating additional revenue through commercialization of biomarker discoveries.

New product introductions can result in disruptions to our revenue patterns and increased sales and marketing costs, and may involve manufacturing challenges that can negatively impact our gross margin.

We have introduced, and we may introduce in the future, new versions of our ProteinChip Systems, Arrays and Software. New product introductions entail training and educating our customers and prospective customers about the new features, protocols and technology encompassed by the new products. This could disrupt our revenue patterns or temporarily lengthen our sales cycles to a greater extent than it would at larger companies with broader product offerings. New product introductions may temporarily increase our sales and marketing costs. Manufacturing new products inherently runs the risk that initial costs may be high as new production processes are introduced, and it is possible that new products may involve quality issues that negatively impact our gross margins. In addition, the introduction of new products makes the continuing sales of previous product versions difficult and may require significant price discounts on such products.

If we fail to continue to develop the technologies we base our products on, we may not be able to successfully foster further adoption of our products and services as an industry standard or develop new product offerings.

The technologies we use for our ProteinChip Systems and related product offerings are new and complex technologies, which are subject to change as new discoveries are made. New discoveries and further progress in our field are essential if we are to maintain and expand the adoption of our product offerings. Development of these technologies remains a substantial risk to us due to various factors including the scientific challenges involved, our ability to find and collaborate with others working in our field, and competing technologies, which may prove more successful than ours. In addition, we have reduced our research and development headcount and expenditures, which may adversely affect our ability to further develop our technology.

If we are unable to provide our customers with software that enables the integration and analysis of large volumes of data, the acceptance and use of our products may be limited.

The successful commercial research application of our products requires that they enable researchers to process and analyze large volumes of data and to integrate the results into other phases of their research. The nature of our software enables a level of integration and analysis that is adequate for many projects. However, if we do not continue to develop and improve the capabilities of our ProteinChip Software to perform more complex analyses of customer samples and to meet

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increasing customer expectations, market acceptance of our products may not increase and we could lose our current customers, which might adversely impact our revenues and we could be unable to develop a profitable business.

Our quarterly operating results may fluctuate significantly due to a number of causes outside our control.

Because the timing of our product orders can vary, we may not be able to reliably predict quarterly revenue and profitability. Our operating results can also vary substantially in any period depending on the mix of products sold. Our quarterly sales and operating results are highly dependent on the volume and timing of orders received during the quarter, as well as the seasonal and cyclical nature of our markets. Historically, a relatively large percentage of our sales have arrived in the last month of each quarter, and often towards the end of such month. Accordingly, a short delay in receiving an order, shipping product, or recognizing revenue from such order may result in substantial quarterly fluctuations in revenue and earnings.

A significant portion of our operating expenses is relatively fixed in nature due to our significant sales, research and development, administration and manufacturing costs. If we cannot adjust spending quickly enough to compensate for a revenue shortfall, this may magnify the adverse impact of such revenue shortfall on our results of operations. As a result, our quarterly operating results could fluctuate, and such fluctuation could cause the market price of our common stock and convertible senior notes to decline. Results from one quarter should not be used as an indication of future performance.

If we are unable to reduce our lengthy sales cycle, our ability to become profitable will be harmed.

Our ability to obtain customers for our products depends in significant part upon the perception that our products and services can help enable protein biomarker discovery, characterization and assay development. From the time we make initial contact with a potential customer until we receive a binding purchase order typically takes between a few weeks to a year or more. Our sales effort requires the effective demonstration of the benefits of our products and may require significant training, sometimes of many different departments within a potential customer. These departments might include research and development personnel and key management. In addition, we may be required to negotiate agreements containing terms unique to each customer. We may expend substantial funds and management effort and may not be able to successfully sell our products or services in a short enough time to achieve profitability.

We will need to raise additional capital in the future, and if we are unable to secure adequate funds on terms acceptable to us, we may be unable to execute our business plan.

We currently believe that current cash resources together with existing debt facilities will be sufficient to meet our anticipated needs for the next 12 months. However, we may need to raise additional capital sooner in order to develop new or enhanced products or services, increase our efforts to discover biomarkers and develop them into diagnostic products, or acquire complementary products, businesses or technologies. If we are unable to obtain financing, or to obtain it on acceptable terms, we may be unable to successfully execute our business plan.

Because our business is highly dependent on key executives, scientists, engineers and sales people, our inability to recruit and retain these people could hinder our business expansion plans.

We are highly dependent on our executive officers, senior scientists, engineers and sales people. In certain countries, a few key individuals are important to our local success. Our product development and marketing efforts could be delayed or curtailed if we lose the services of any of these people. To expand our research, product development and sales efforts, we need people skilled in areas such as bioinformatics, biochemistry, information services, manufacturing, sales, marketing and technical support. Competition for qualified employees is intense. We will not be able to expand our business if we are unable to hire, train and retain a sufficient number of qualified employees. During 2004 and 2005, we took steps to reduce our headcount and our voluntary employee turnover has increased from historic levels. In addition, the adoption of Statement of Financial Accounting Standards No. 123 (Revised), Share-Based Payment , on January 1, 2006, which requires us to expense all stock-based compensation, may cause us to change the manner in which we compensate our employees, which could negatively impact our ability to recruit and retain qualified employees.

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We face intense competition in our current and potential markets and if our competitors develop new technologies or products, our products may not achieve market acceptance and may fail to capture market share.

Competition in our existing and potential markets is intense and we expect it to increase. Currently, our principal competition comes from other technologies that are used to perform many of the same functions for which we market our ProteinChip System. The major technologies that compete with our ProteinChip System are liquid chromatography-mass spectrometry and 2D-gel electrophoresis-mass spectrometry. In the life science research market, competitive protein research tools and services are currently provided by a number of companies, including several which are larger than Ciphergen. In the diagnostics market, there are several larger direct competitors. In many instances, our competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales, distribution and service organizations. Additionally, our potential customers may internally develop competing technologies. If we fail to compete effectively with these technologies and products, or if competitors develop significant improvements in protein detection systems, develop systems that are easier to use, or introduce comparable products that are less expensive, our products may not achieve market acceptance and our sales may decrease.

If we are unable to maintain our licensed rights to the SELDI technology, we may lose the right to produce ProteinChip Systems and products based on the SELDI technology and the right to provide services and information related thereto.

Our commercial success depends on our ability to maintain our sublicenses to the SELDI technology. All of our revenue from continuing operations was derived from SELDI-based products within the scope of the Baylor SELDI patents. Pursuant to the settlement of the litigation between Ciphergen, Molecular Analytical Systems (MAS), LumiCyte and T. William Hutchens, MAS cannot terminate Ciphergen s rights under the sublicenses. However, Baylor College of Medicine has the right to terminate its license with MAS in case of material breach by MAS. If the agreements between Baylor College of Medicine and MAS were terminated and we were unable to obtain a license to these rights from Baylor College of Medicine, we would be precluded from selling any SELDI-based products within the scope of the Baylor SELDI patents, we would no longer generate revenue from the sale of these products and we would have to revise our business direction and strategy.

If the government grants a license to the SELDI technology to others, it may harm our business.

Some of the inventions covered by our sublicense agreements with MAS were developed under a grant from an agency of the U.S. government and therefore, pursuant to the Bayh-Dole Act and regulations promulgated thereunder, the government has a paid-up, nonexclusive nontransferable license to those inventions and will be able in limited circumstances to grant a license to others on reasonable terms. We are not aware of any basis for the government to exercise such rights, but if circumstances change and the government exercises such rights, our business could be harmed.

If we fail to maintain our rights to utilize intellectual property directed to diagnostic biomarkers, we may not be able to offer diagnostic tests using those biomarkers.

One aspect of our business plan is to develop diagnostic tests based on certain biomarkers which we have the right to utilize through licenses with our academic collaborators, such as The Johns Hopkins School of Medicine and the University of Texas M.D. Anderson Cancer Center. In some cases, our collaborators own the entire right to the biomarkers. In other cases we co-own the biomarkers with our collaborator. If, for some reason, we lose our license to biomarkers owned entirely by our collaborators, we may not be able to use those biomarkers in diagnostic tests. If we lose our exclusive license to biomarkers co-owned by us and our collaborators, our collaborators may license their share of the intellectual property to a third party that may compete with us in offering the diagnostic test.

We have drawn funds from the $10 million secured line of credit provided by Quest Diagnostics. If we fail to achieve the loan forgiveness milestones set forth therein, we will be responsible for full repayment of the loan.

In connection with the strategic alliance with Quest Diagnostics, Quest Diagnostics agreed to provide us with a $10 million secured line of credit, from which we had drawn a total of approximately $3.7 million as of March 31, 2006. Borrowings may be made in monthly increments of up to approximately $417,000 over a two year period, with accrued interest to be paid monthly. Funds from this collateralized line of credit may only be used to pay certain costs

and expenses directly related to the strategic alliance, with forgiveness of the repayment obligations based upon our achievement of milestones related to the development, regulatory approval and commercialization of laboratory tests. Should we fail to achieve these milestones, we would be responsible for the repayment of the outstanding principal amount of any such loans on or before July 22, 2010.

If a competitor infringes our proprietary rights, we may lose any competitive advantage we may have as a result of diversion of management time, enforcement costs and the loss of the exclusivity of our proprietary rights.

Our commercial success depends in part on our ability to maintain and enforce our proprietary rights. We rely on a combination of patents, trademarks, copyrights and trade secrets to protect our technology and brand. In addition to our

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licensed SELDI technology, we also have submitted patent applications directed to subsequent technological improvements and application of the SELDI technology, including patent applications covering biomarkers that may have diagnostic or therapeutic utility. Our patent applications may not result in additional patents being issued.

If competitors engage in activities that infringe our proprietary rights, our management s focus will be diverted and we may incur significant costs in asserting our rights. We may not be successful in asserting our proprietary rights, which could result in our patents being held invalid or a court holding that the competitor is not infringing, either of which would harm our competitive position. We cannot be sure that competitors will not design around our patented technology.

We also rely upon the skills, knowledge and experience of our technical personnel. To help protect our rights, we require all employees and consultants to enter into confidentiality agreements that prohibit the disclosure of confidential information. These agreements may not provide adequate protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure.

If others successfully assert their proprietary rights against us, we may be precluded from making and selling our products or we may be required to obtain licenses to use their technology.

Our success also depends on avoiding infringing on the proprietary technologies of others. If a third party were to assert claims that we are violating their patents, we might incur substantial costs defending ourselves in lawsuits against charges of patent infringement or other unlawful use of another s proprietary technology. Any such lawsuit may not be decided in our favor, and if we are found liable, we may be subject to monetary damages or injunction against using their technology. We may also be required to obtain licenses under their patents and such licenses may not be available on commercially reasonable terms, if at all.

We rely on single-source suppliers for many components of our ProteinChip Systems as well as processing services for our ProteinChip Arrays, and if we are unable to obtain these components and processing services, we would be harmed and our operating results would suffer.

We depend on many single-source suppliers for the necessary raw materials and components required to manufacture our products. We also rely on some single-source subcontractors for certain outsourced manufacturing services. Some of these suppliers are small companies without extensive financial resources. Because of the limited quantities of products we currently manufacture, it is not economically feasible to qualify and maintain alternate vendors for most components of our ProteinChip Readers and processing services for our ProteinChip Arrays. We have occasionally experienced delays in receiving raw materials, components and services, resulting in manufacturing delays. If we are unable to procure the necessary raw materials, components or services from our current vendors, we will have to arrange new sources of supply and our raw materials and components shipments could be delayed, harming our ability to manufacture our products, and our ability to sustain or increase revenue could be harmed. As a result, our costs could increase and our profitability could be harmed.

If we fail to maintain certain distribution and patent license agreements, we may have to stop selling certain products and this may harm our revenue.

We sell certain products under either OEM or distribution or patent license agreements. These include arrangements with Beckman Coulter with respect to selling a customized version of the Biomek 3000 Workstation, with Salford Systems with respect to selling Biomarker Patterns software, and with Applied Biosystems / MDS Sciex with respect to selling our ProteinChip Tandem MS Interfaces. If we fail to maintain or extend after their expiration the underlying agreements with these companies, we would have to stop selling these particular products and may have to seek alternate products to sell, as a result of which our sales may be harmed.

If there are reductions in research funding, the ability of our existing and prospective customers to purchase our products could be seriously harmed.

A significant portion of our products are sold to universities, government research laboratories, private foundations and other institutions where funding is dependent upon grants from government agencies, such as the National Institutes of Health. Government funding for research and development has fluctuated significantly in the past due to changes in congressional appropriations. Research funding by the U.S. government or the governments of other countries may be significantly reduced in the future. Any such reductions may seriously harm the ability of our existing and prospective research customers to purchase our products or may reduce the number of ProteinChip

Arrays used. Limitations in funding for commercial, biotechnology and pharmaceutical companies and academic institutions that are the potential customers for our ProteinChip Systems and Arrays, and general cost containment pressures for biomedical research may limit our ability to sell our products and services.

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If we or our future potential partners fail to comply with FDA requirements, we may not be able to market our products and services and may be subject to stringent penalties; further improvements to our manufacturing operations may be required that would entail additional costs.

Currently, the FDA does not actively regulate clinical laboratory tests, or home brews , that have been developed and used by the laboratory to conduct in-house testing. Active ingredients (known as analyte specific reagents or ASRs) that are sold to laboratories for use in tests developed in-house by clinical laboratories are generally exempt from the FDA s pre-market review requirements. We believe that ASRs that we may provide will fall within those exemptions. However, the FDA has publicly stated it is reevaluating its ASR policy and we expect that revisions to FDA policies may be implemented in the future that may have the effect of increasing the regulatory burden on manufacturers of these devices. The commercialization of our products could be impacted by being delayed, halted or prevented. If the FDA were to view any of our actions as non-compliant, it could initiate enforcement action such as a warning letter and possible imposition of penalties. Finally, ASRs that we may provide will be subject to a number of FDA requirements, including compliance with the FDA s QSRs, which establish extensive regulations for quality assurance and control as well as manufacturing procedures. Failure to comply with these regulations could result in enforcement action for us or our potential partners. Adverse FDA action in any of these areas could significantly increase our expenses and limit our revenue and profitability. Although we are ISO 9001:2000 certified in our ProteinChip manufacturing processes, we will need to undertake additional steps to maintain our operations in line with FDA QSR requirements. Our manufacturing facilities will be subject to periodic regulatory inspections by the FDA and other federal and state regulatory agencies. We have not yet been subject to an FDA inspection. We may not satisfy such regulatory requirements, and any such failure to do so would have an adverse effect on our diagnostics efforts.

Our diagnostic efforts may cause us to have significant product liability exposure.

The testing, manufacturing and marketing of medical diagnostics entails an inherent risk of product liability claims. Potential product liability claims may exceed the amount of our insurance coverage or may be excluded from coverage under the terms of the policy. Our existing insurance will have to be increased in the future if we are successful at introducing diagnostic products and this will increase our costs. In the event that we are held liable for a claim against which we are not indemnified or for damages exceeding the limits of our insurance coverage, our liabilities could exceed our total assets.

Business interruptions could limit our ability to operate our business.

Our operations as well as those of the collaborators on which we depend are vulnerable to damage or interruption from fire, natural disasters, computer viruses, human error, power shortages, telecommunication failures, international acts of terror and similar events. Our only production facility is located in Fremont, California, where we also have laboratories. Although we have certain business continuity plans in place, we have not established a formal comprehensive disaster recovery plan, and our back-up operations and our business interruption insurance may not be adequate to compensate us for losses we may suffer. A significant business interruption could result in losses or damages incurred by us and require us to cease or curtail our operations.

Legislative actions resulting in higher compliance costs are likely to adversely impact our future financial position, cash flows and results of operations.

Compliance with changing regulation of corporate governance and public disclosure will result in additional expenses. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq National Market listing requirements, are resulting in increased compliance costs. Compliance with these evolving standards will result in increased general and administrative expenses and may cause a diversion of management time and attention from revenue-generating activities to compliance activities.

Our business is subject to risks from international operations.

We conduct business globally. Accordingly, our future results could be materially adversely affected by a variety of uncontrollable and changing factors including, among others, foreign currency exchange rates; regulatory, political, or economic conditions in a specific country or region; trade protection measures and other regulatory requirements; and natural disasters. Any or all of these factors could have a material adverse impact on our future international

business. In certain countries, a few key individuals are important to our local success. In addition, China does not currently have a comprehensive and highly developed legal system, particularly with respect to the protection of intellectual property rights. As a result, enforcement of existing and future laws and contracts is uncertain, and the implementation and interpretation of such laws may be inconsistent. Such inconsistency could lead to piracy and degradation of our intellectual property protection.

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We are exposed to fluctuations in the exchange rates of foreign currency.

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. With our ownership of Ciphergen Biosystems KK, a significant percentage of our net sales are exposed to foreign currency risk. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results.

We are subject to environmental laws and potential exposure to environmental liabilities.

We are subject to various international, federal, state and local environmental laws and regulations that govern our operations, including the handling and disposal of nonhazardous and hazardous wastes, the recycling and treatment of electrical and electronic equipment, and emissions and discharges into the environment. Failure to comply with such laws and regulations could result in costs for corrective action, penalties or the imposition of other liabilities. We also are subject to laws and regulations that impose liability and clean-up responsibility for releases of hazardous substances into the environment. Under certain of these laws and regulations, a current or previous owner or operator of property may be liable for the costs of remediating hazardous substances or petroleum products on or from its property, without regard to whether the owner or operator knew of, or caused, the contamination, as well as incur liability to third parties impacted by such contamination. The presence of, or failure to remediate properly, such substances could adversely affect the value and the ability to transfer or encumber such property. Based on currently available information, although there can be no assurance, we believe that such costs and liabilities have not had and will not have a material adverse impact on our financial results.

Anti-takeover provisions in our charter, bylaws and Stockholder Rights Plan and under Delaware law could make a third party acquisition of us difficult.

Our certificate of incorporation, bylaws and Stockholder Rights Plan contain provisions that could make it more difficult for a third party to acquire us, even if doing so might be deemed beneficial by our stockholders. These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. We are also subject to certain provisions of Delaware law that could delay, deter or prevent a change in control of us.

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The rights issued pursuant to our Stockholder Rights Plan will become exercisable the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person acquiring 15% or more of our common stock) will be entitled to acquire, in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged, with a value equal to twice the rights exercise price.

Because we do not intend to pay dividends, our stockholders will benefit from an investment in our common stock only if it appreciates in value.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the expansion of our business and do not expect to pay any cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend entirely upon any future appreciation. There is no guarantee that our common stock will appreciate in value or even maintain the price at which our investor purchased his shares.

Risks Related to Our Convertible Senior Notes and Common Stock

Substantial leverage and debt service obligations may adversely affect our cash flows.

In connection with the sale of the convertible senior notes (the notes), we incurred $30 million of indebtedness. As a result of this indebtedness, our principal and interest payment obligations increased substantially. The degree to which we are leveraged could, among other things:

make it difficult for us to make payments on the notes;

make it difficult for us to obtain financing for working capital, acquisitions or other purposes on favorable terms, if at all;

make us more vulnerable to industry downturns and competitive pressures; and

limit our flexibility in planning for, or reacting to changes in, our business.

Our ability to meet our debt service obligations will depend upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control.

The notes are unsecured, and future indebtedness could effectively rank senior to the notes.

The notes are unsecured and will rank equal in right of payment with our existing and future unsecured and unsubordinated indebtedness. The notes will be effectively subordinated to any secured debt to the extent of the value of the assets that secure the indebtedness. The notes will also be structurally subordinated to all indebtedness and other liabilities, including trade payables and lease obligations, of our existing and future subsidiaries. In the event of our bankruptcy, liquidation or reorganization or upon acceleration of the notes, payment on the notes could be less, ratably, than on any secured indebtedness. We may not have sufficient assets remaining to pay amounts due on any or all of the notes then outstanding.

The indenture governing the notes does not prohibit or limit us or our subsidiaries from incurring additional indebtedness and other liabilities, or from pledging assets to secure such indebtedness and liabilities. The incurrence of additional indebtedness and, in particular, the granting of a security interest to secure the indebtedness, could adversely affect our ability to pay our obligations on the notes. We anticipate that we may incur additional indebtedness from time to time in the future.

The notes are not protected by restrictive covenants, including financial covenants.

Neither we nor our subsidiaries are restricted from incurring additional debt, including senior debt, or liabilities under the indenture. In addition, the indenture does not restrict us or any of our subsidiaries from paying dividends or issuing or repurchasing securities. If we or our subsidiaries were to incur additional debt or liabilities, our ability to pay our obligations on the notes could be adversely affected.

We may be unable to repay, repurchase or redeem the notes.

At maturity, the entire outstanding principal amount of the notes will become due and payable by us. Upon a change in control, as defined in the indenture, note holders may require us to repurchase all or a portion of their notes.

We may not have enough funds or be able to arrange for additional financing to pay the principal at maturity or to repurchase the notes on a change in control. Future credit agreements or other agreements relating to our indebtedness may restrict the redemption or repurchase of the notes and provide that a change in control constitutes an event of default. If the maturity date or a change in

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control occurs at a time when we are prohibited from repaying or repurchasing the notes, we could seek the consent of our lenders to purchase the notes or we could attempt to refinance this debt. If we do not obtain the necessary consents or cannot refinance the debt on favorable terms, or at all, we will be unable to repay or repurchase the notes. Our failure to repay the notes at maturity or repurchase tendered notes would constitute an event of default under the indenture, which might constitute a default under the terms of our other debt. Our obligation to offer to purchase the notes upon a change in control would not necessarily afford note holders protection in the event of a highly leveraged transaction, reorganization, merger or similar transaction involving us.

There may not be an active, liquid market for our common stock or the notes.

There is no guarantee that an active trading market for our common stock will be maintained on the Nasdaq Stock Market s National Market. Investors may not be able to sell their shares quickly or at the latest market price if trading in our stock is not active. An active trading market for the notes may not be maintained. If an active market for the notes is not sustained, the trading price of the notes could decline significantly. The notes are eligible for trading on the PORTAL Market. We do not intend to apply for listing of the notes on any securities exchange.

The notes and the common stock issuable upon conversion of the notes may be subject to restrictions on resale.

We entered into a registration rights agreement with the initial purchasers of the notes, pursuant to which we filed a shelf registration statement covering the resale of the notes and the common stock issuable upon conversion of the notes. If the effectiveness of the registration statement is not maintained, the liquidity and price of the notes and common stock issuable upon conversion of the notes would be adversely affected and note holders could lose all or part of their investment.

During significant periods from 2003 to 2006, the price at which our common stock could be purchased on the Nasdaq National Market was lower than the conversion price of the notes, and our stock price may be lower than the conversion price in the future.

Prior to electing to convert notes, the note holder should compare the price at which our common stock is trading in the market to the conversion price of the notes. Our common stock trades on the Nasdaq National Market under the symbol CIPH. The initial conversion price of the notes is approximately $9.19 per share. The market prices of our securities are subject to significant fluctuations. Such fluctuations, as well as economic conditions generally, may adversely affect the market price of our securities, including our common stock and the notes.

The notes may not be rated or may receive a lower rating than anticipated.

We believe it is unlikely that the notes will be rated. However, if one or more rating agencies rates the notes and assigns the notes a rating lower than the rating expected by investors, reduces their rating in the future or indicates that it will have their ratings on the notes under surveillance or review with possible negative implications, the market price of the notes and our common stock would be harmed. In addition, a ratings downgrade could adversely affect our ability to access capital.

Our stock price has been highly volatile, and an investment in our stock could suffer a decline in value, adversely affecting the value of the notes or the shares into which those notes may be converted.

The trading price of our common stock has been highly volatile and could continue to be subject to wide fluctuations in price in response to various factors, many of which are beyond our control, including:

- actual or anticipated period-to-period fluctuations in financial results;
- failure to achieve, or changes in, financial estimates by securities analysts;
- announcements of new products or services or technological innovations by us or our competitors;
- developments regarding actual or potential discoveries of biomarkers by us or others;
- comments or opinions by securities analysts or major stockholders;
- conditions or trends in the pharmaceutical, biotechnology and life science industries;

announcements by us of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

developments regarding our patents or other intellectual property or that of our competitors;

litigation or threat of litigation;

additions or departures of key personnel;

sales of our common stock;

limited daily trading volume; and

economic and other external factors or disasters or crises.

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In addition, the stock market in general, and the Nasdaq National Market and the market for technology companies in particular, have experienced significant price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Further, there has been significant volatility in the market prices of securities of life science companies. These broad market and industry factors may seriously harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has often been instituted. A securities class action suit against us could result in substantial costs, potential liabilities and the diversion of management s attention and resources.

Future sales of our common stock in the public market could adversely affect the trading price of our common stock, the value of the notes and our ability to raise funds in new stock offerings.

Future sales of substantial amounts of our common stock in the public market, or the perception that such sales are likely to occur, could affect prevailing trading prices of our common stock and the value of the notes. As of March 31, 2006, we had:

- 35,998,881 shares of common stock outstanding;
- 6,055,071 shares of common stock reserved for issuance upon exercise of options outstanding under our stock option plans with a weighted average exercise price of $4.42 per share;
- in addition to the shares reserved for issuance upon the exercise of options referred to in the preceding bullet point, 2,112,259 shares reserved for future issuance under our stock option and employee stock purchase plans;
- a warrant outstanding for 2,200,000 shares of common stock at a purchase price of $3.50 per share; and
- 25,000 shares of common stock potentially issuable to Gail Page, President and Chief Executive Officer of Ciphergen, contingent upon the achievement of a specific diagnostic milestone.

Because the notes are convertible into common stock only at a specific conversion price, a decline in our common stock price may cause the value of the notes to decline.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The following exhibits have been filed with this report:

2.1(1)	Share Purchase Agreement between Ciphergen Biosystems, Inc. and LumiCyte, Inc. dated May 28, 2003
2.2(2)	Asset Purchase Agreement between Ciphergen Biosystems, Inc. and Pall Corporation dated October 27, 2004
3.2(3)	Amended and Restated Certificate of Incorporation of Registrant
3.4(3)	Amended and Restated Bylaws of Registrant
3.5(4)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of Ciphergen Biosystems, Inc.
4.1(3)	Form of Registrant s Common Stock Certificate
4.2(4)	Preferred Shares Rights Agreement dated March 20, 2002 between Ciphergen Biosystems, Inc. and Continental Stock Transfer & Trust Company
4.3(5)	Indenture between Ciphergen Biosystems, Inc. and U.S. Bank National Association dated August 22, 2003
4.4(6)	Amendment to Rights Agreement between the Company and Wells Fargo Bank, N.A. dated July 22, 2005
4.5(7)	Amendment to Rights Agreement between the Company and Wells Fargo Bank, N.A. dated September 30, 2005
10.55(8)	Consulting Agreement between Ciphergen Biosystems, Inc. and Matthew J. Hogan dated March 22, 2006
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 (a) of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 (a) of the Sarbanes-Oxley Act of 2002
32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the corresponding exhibits in our Form 8-K filed with the Securities and Exchange Commission on June 11, 2003.

(2) Incorporated by reference to the corresponding exhibit in our Form 8-K filed with the Securities and Exchange Commission on December 6, 2004.

(3) Incorporated by reference to exhibits (with same exhibit number) to Ciphergen Biosystems Registration Statement on Form S-1 (File No. 333-32812) declared effective on September 28, 2000.

(4) Incorporated by reference to our Registration Statement on Form 8-A filed with the Securities and Exchange Commission on March 21, 2002.

(5) Incorporated by reference to our Registration Statement on Form S-3 filed with the Securities and Exchange Commission on October 8, 2003.

(6) Incorporated by reference to our Form 8-K filed with the Securities and Exchange Commission on July 28, 2005.

(7) Incorporated by reference to our Form 8-K filed with the Securities and Exchange Commission on October 4, 2005.

(8) Incorporated by reference to exhibit (with same exhibit number) in our Form 8-K filed with the Securities and Exchange Commission on March 23, 2006.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

May 15, 2006

CIPHERGEN BIOSYSTEMS, INC.

(Registrant)

/s/ Gail S. Page

Gail S. Page
President, Chief Executive Officer and Director

/s/ Daniel M. Caserza

Daniel M. Caserza
Vice President and Interim Chief Financial Officer

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