

CYTOKINETICS INC  
Form 10-Q  
August 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2006**

**or**

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

**Commission file number: 000-50633  
CYTOKINETICS, INCORPORATED  
(Exact name of registrant as specified in its charter)**

**Delaware  
(State or other jurisdiction of  
incorporation or organization)**

**94-3291317  
(I.R.S. Employer  
Identification Number)**

**280 East Grand Avenue  
South San Francisco, California  
(Address of principal executive offices)**

**94080  
(Zip Code)**

**Registrant's telephone number, including area code: (650) 624-3000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant 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  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Number of shares of common stock, \$0.001 par value, outstanding as of July 31, 2006: 36,633,133

**CYTOKINETICS, INCORPORATED**  
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**Table of Contents**PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

**CYTOKINETICS, INCORPORATED**  
**(A DEVELOPMENT STAGE ENTERPRISE)**  
**CONDENSED BALANCE SHEETS**  
(In thousands, except share and per share data)  
(Unaudited)

	<b>June 30, 2006</b>	<b>December 31, 2005 (1)</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 49,766	\$ 13,515
Short-term investments	45,155	62,697
Related party accounts receivable	71	576
Related party notes receivable short-term portion	160	151
Prepaid and other current assets	2,438	1,925
Total current assets	97,590	78,864
Property and equipment, net	5,920	6,178
Related party notes receivable long-term portion	442	451
Restricted cash	5,100	5,172
Other assets	526	796
Total assets	\$ 109,578	\$ 91,461
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 1,890	\$ 2,352
Accrued liabilities	5,502	4,137
Related party payables and accrued liabilities	268	649
Short-term portion of equipment financing lines	2,990	2,726
Deferred revenue		1,400
Total current liabilities	10,650	11,264
Long-term portion of equipment financing lines	6,136	6,636
Total liabilities	16,786	17,900
Stockholders equity:		
Convertible preferred stock, \$0.001 par value:		
Authorized: 10,000,000 shares; Issued and outstanding: none		
Common stock, \$0.001 par value:		
Authorized: 120,000,000 shares; Issued and outstanding: 36,613,565 shares in 2006 and 29,710,895 shares in 2005		
	37	30
Additional paid-in capital	294,336	249,521
Deferred stock-based compensation	(1,752)	(2,452)
Accumulated other comprehensive loss	(56)	(14)

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Deficit accumulated during the development stage	(199,773)	(173,524)
Total stockholders' equity	92,792	73,561
Total liabilities and stockholders' equity	\$ 109,578	\$ 91,461

(1) The condensed balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

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

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**CYTOKINETICS, INCORPORATED**  
**(A DEVELOPMENT STAGE ENTERPRISE)**  
**CONDENSED STATEMENTS OF OPERATIONS**  
(In thousands, except per share data)  
(Unaudited)

	<b>Three Months</b>		<b>Six Months Ended</b>		<b>Period</b>
	<b>Ended</b>				<b>from</b>
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>August 5,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>1997</b>
					<b>(date of</b>
					<b>inception)</b>
					<b>to June</b>
					<b>30,</b>
					<b>2006</b>
Revenues:					
Research and development revenues from related party	\$ 744	\$ 1,333	\$ 1,462	\$ 2,905	\$ 38,704
Research and development, grant and other revenues	2	308	4	608	2,955
License revenues from related party	700	700	1,400	1,400	14,000
Total revenues	1,446	2,341	2,866	4,913	55,659
Operating expenses:					
Research and development (1)	12,397	10,039	23,664	20,576	204,539
General and administrative (1)	3,938	3,403	7,560	6,546	61,059
Total operating expenses	16,335	13,442	31,224	27,122	265,598
Operating loss	(14,889)	(11,101)	(28,358)	(22,209)	(209,939)
Interest and other income	1,228	688	2,357	1,400	14,063
Interest and other expense	(125)	(127)	(248)	(261)	(3,897)
Net loss	\$ (13,786)	\$ (10,540)	\$ (26,249)	\$ (21,070)	\$ (199,773)
Net loss per common share basic and diluted	\$ (0.38)	\$ (0.37)	\$ (0.74)	\$ (0.74)	
Weighted-average number of shares used in computing net loss per common share basic and diluted	36,376	28,514	35,317	28,447	

(1) Includes the following stock-based compensation charges:

Research and development	\$ 679	\$ 190	\$ 1,235	\$ 419	\$ 4,083
General and administrative	738	155	1,120	329	2,825

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

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**CYTOKINETICS, INCORPORATED**  
**(A DEVELOPMENT STAGE ENTERPRISE)**  
**CONDENSED STATEMENTS OF CASH FLOWS**

(In thousands)  
(Unaudited)

	<b>Six Months Ended</b>		<b>Period from</b>
	<b>June 30,</b>	<b>June 30,</b>	<b>August 5, 1997</b>
	<b>2006</b>	<b>2005</b>	<b>(date of</b>
			<b>inception)</b>
			<b>to June 30,</b>
			<b>2006</b>
<b>Cash flows from operating activities:</b>			
Net loss	\$ (26,249)	\$ (21,070)	\$ (199,773)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization of property and equipment	1,495	1,559	16,728
Loss on disposal of property and equipment	1		343
Gain on sale of investments			(84)
Allowance for doubtful accounts			191
Non-cash expense related to warrants issued for equipment financing lines and facility lease			41
Non-cash interest expense	46	46	289
Non-cash expense for acceleration of options			20
Non-cash forgiveness of loan to officer	2		148
Stock-based compensation	2,355	748	6,908
Changes in operating assets and liabilities:			
Related party accounts receivable	503	(157)	(372)
Prepaid and other assets	(289)	(56)	(2,777)
Accounts payable	421	(1,030)	1,933
Accrued liabilities	1,160	349	5,257
Related party payables and accrued liabilities	(381)	365	268
Deferred revenue	(1,400)	(1,400)	
Net cash used in operating activities	(22,336)	(20,646)	(170,880)
<b>Cash flows from investing activities:</b>			
Purchases of investments	(70,898)	(30,918)	(521,056)
Proceeds from sales and maturities of investments	88,423	50,012	475,955
Purchases of property and equipment	(1,898)	(847)	(22,857)
Proceeds from sale of property and equipment	6		50
(Increase) decrease in restricted cash	72	844	(5,100)
Issuance of related party notes receivable			(1,146)
Proceeds from payments of related party notes receivable		100	507
Unrealized loss on investment	(26)		(26)
Net cash provided by (used in) investing activities	15,679	19,191	(73,673)
<b>Cash flows from financing activities:</b>			

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Proceeds from initial public offering, net of issuance costs			94,004
Proceeds from sale of common stock to related party			7,000
Proceeds from registered direct offering, net of issuance costs	31,993		31,993
Proceeds from draw down of Committed Equity Financing Facility	10,589		16,136
Proceeds from other issuances of common stock	563	503	3,430
Proceeds from issuance of preferred stock, net of issuance costs			133,172
Repurchase of common stock	(1)	(23)	(67)
Proceeds from equipment financing lines	1,108		18,715
Repayment of equipment financing lines	(1,344)	(1,176)	(10,064)
Net cash provided by (used in) financing activities	42,908	(696)	294,319
Net increase (decrease) in cash and cash equivalents	36,251	(2,151)	49,766
Cash and cash equivalents, beginning of period	13,515	13,061	
Cash and cash equivalents, end of period	\$ 49,766	\$ 10,910	\$ 49,766

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



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**CYTOKINETICS, INCORPORATED**  
**(A DEVELOPMENT STAGE ENTERPRISE)**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**

**Note 1. Organization and Summary of Significant Accounting Policies****Overview**

Cytokinetics, Incorporated (the Company, we or our) was incorporated under the laws of the state of Delaware on August 5, 1997 to discover, develop and commercialize novel small molecule drugs specifically targeting the cytoskeleton. The Company has been primarily engaged in conducting research, developing drug candidates and product technologies, and raising capital.

The Company has funded its operations primarily through sales of common stock and convertible preferred stock, contract payments under its collaboration agreements, debt financing arrangements, government grants and interest income.

The Company's registration statement for its initial public offering was declared effective by the Securities and Exchange Commission on April 29, 2004. The Company's common stock commenced trading on the Nasdaq National Market on April 29, 2004 under the trading symbol CYTK.

Prior to achieving profitable operations, the Company intends to continue to fund operations through the additional sale of equity securities, payments from strategic collaborations, government grant awards, debt financing and interest income.

**Basis of Presentation**

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements include all adjustments (consisting only of normal recurring adjustments) that management believes are necessary for the fair statement of the balances and results for the periods presented. These interim financial statement results are not necessarily indicative of results to be expected for the full fiscal year or any future interim period.

The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date. The financial statements and related disclosures have been prepared with the presumption that users of the interim financial statements have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these financial statements should be read in conjunction with the audited financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2005.

**Comprehensive Loss**

Comprehensive loss consists of net loss and other comprehensive gain (loss). Other comprehensive gain (loss) includes certain changes in stockholder's equity that are excluded from net loss. Comprehensive loss and its components for the three and six months ended June 30, 2006 and 2005 are as follows (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Net loss	\$ (13,786)	\$ (10,540)	\$ (26,249)	\$ (21,070)
Change in unrealized gain (loss) on investments	(56)	86	(42)	93
Comprehensive loss	\$ (13,842)	\$ (10,454)	\$ (26,291)	\$ (20,977)

**Table of Contents****Restricted Cash**

In accordance with the terms of the Company's line of credit agreements with General Electric Capital Corporation (GE Capital), the Company is obligated to maintain a certificate of deposit with the lender. The balance of the certificate of deposit was \$5.1 million and \$5.2 million at June 30, 2006 and December 31, 2005, respectively, and was classified as restricted cash.

**Stock-based Compensation**

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, which establishes accounting for share-based payment awards made to employees and directors including employee stock options and employee stock purchases. Under the provisions of this statement, stock-based compensation cost is measured at the grant date based on the calculated fair value of the award, and is recognized as an expense on a straight-line basis over the employee's requisite service period, generally the vesting period of the award. The Company elected the modified prospective transition method for awards granted subsequent to April 29, 2004, the date of its initial public offering (IPO), and the prospective transition method for awards granted prior to its IPO. Prior periods are not revised for comparative purposes under either transition method. The following table summarizes stock-based compensation related to employee stock options and employee stock purchases under SFAS No. 123R for the three and six months ended June 30, 2006, which was allocated as follows (in thousands):

	<b>Three Months Ended June 30, 2006</b>	<b>Six Months Ended June 30, 2006</b>
Research and development	\$ 679	\$ 1,235
General and administrative	738	1,120
Stock-based compensation included in operating expenses	\$ 1,417	\$ 2,355

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options and employee stock purchase plan shares. The key input assumptions used to estimate fair value of these awards include the exercise price of the award, the expected option term, the expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term and the Company's expected dividend yield, if any.

The fair value of stock options and employee stock purchase plan shares was estimated on the date of grant using the Black-Scholes option pricing model based on the following weighted average assumptions:

	<b>Employee Stock Options</b>		<b>Employee Stock Purchase Plan</b>	
	<b>Three Months Ended June 30, 2006</b>	<b>Six Months Ended June 30, 2006</b>	<b>Three Months Ended June 30, 2006</b>	<b>Six Months Ended June 30, 2006</b>
Risk-free interest rate	4.99%	4.68%	4.96%	4.96%
Volatility	72%	74%	72%	72%
Expected life (in years)	6.25	6.25	1.25	1.25
Expected dividend yield	0.00%	0.00%	0.00%	0.00%

The Company estimates the expected term of options granted by taking the average of the vesting term and the contractual term of the options, referred to as the simplified method in accordance with Staff Accounting Bulletin (SAB) No. 107, Share-Based Payment. The Company estimates the volatility of our common stock by using an average of historical stock price volatility of comparable companies. The risk-free interest rate that the Company uses in the option pricing model is based on the U.S. Treasury zero-coupon issues with remaining terms similar to the expected terms on the options. The Company does not anticipate paying dividends in the foreseeable future and

therefore uses an expected dividend yield of zero in the option pricing model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. Historical data is used to estimate pre-vesting option forfeitures and record stock-based compensation expense only on those awards that are expected to vest.

As a result of adopting SFAS No. 123R on January 1, 2006, the Company's net loss for the three and six months ended June 30, 2006 increased by \$1.1 million and \$1.7 million, respectively, than if it had continued to account for stock-based compensation under APB No. 25. As of June 30, 2006, there was \$9.0 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company's stock option plans, which is expected to be recognized over a weighted-average period of 3.17 years.

The Company amortizes deferred stock-based compensation recorded prior to adoption of SFAS No. 123R for stock options granted prior to our IPO. Fair value of these awards has been calculated at grant date using the intrinsic value method as prescribed in Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees. At June 30, 2006, the balance of

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deferred stock based compensation was \$1.8 million. The remaining balance of deferred employee stock-based compensation will be amortized in future years as follows, assuming no cancellations of the related stock options: \$0.6 million the remainder of 2006, \$0.8 million in 2007 and \$0.4 million in 2008.

Prior to January 1, 2006, the Company accounted for stock-based compensation to employees in accordance with APB No. 25 and related interpretations. The Company also followed the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation, and complied with the disclosure requirements of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure: an Amendment of FASB Statement No. 123. The following table illustrates the effects on net loss and earnings per share for the three and six months ended June 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to all stock-based employee awards except for those options granted prior to the Company's IPO in April 2004, which were valued for proforma disclosure purposes using the minimum value method (in thousands, except per share data):

	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005</b>
Net loss, as reported	\$ (10,540)	\$ (21,070)
Deduct: Total stock-based employee compensation determined under fair value based method for all awards	(666)	(1,141)
Adjusted net loss	\$ (11,206)	\$ (22,211)
Net loss per common share, basic and diluted:		
As reported	\$ (0.37)	\$ (0.74)
Adjusted	\$ (0.39)	\$ (0.78)

The value of each employee stock option granted is estimated on the date of grant under the fair value method using the Black-Scholes option pricing model. Prior to our IPO on April 29, 2004, the value of each employee stock option grant was estimated on the date of grant using the minimum value method. Under the minimum value method, a volatility factor of 0% is assumed. The value of employee stock options and employee stock purchase plan shares was estimated based the following weighted average assumptions:

	<b>Employee Stock Options</b>		<b>Employee Stock Purchase Plan</b>	
	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005</b>	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005</b>
Risk-free interest rate	4.09%	4.17%	2.84%	2.84%
Volatility	80%	80%	78%	78%
Expected life (in years)	5.0	5.0	1.29	1.29
Expected dividend yield	0.00%	0.00%	0.00%	0.00%

**Note 2. Net Loss Per Share**

Basic net loss per common share is computed by dividing net loss by the weighted-average number of vested common shares outstanding during the period. Diluted net loss per common share is computed by giving effect to all potentially dilutive common shares, including outstanding options, common stock subject to repurchase and warrants. Following is a reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per common share (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Numerator net loss	\$ (13,786)	\$ (10,540)	\$ (26,249)	\$ (21,070)
Denominator:				
Weighted-average common shares outstanding	36,394	28,582	35,341	28,532
Less: Weighted-average shares subject to repurchase	(18)	(68)	(24)	(85)
Weighted-average shares used in computing basic and diluted net loss per common share	36,376	28,514	35,317	28,447

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The following outstanding instruments were excluded from the computation of diluted net loss per common share for the periods presented, because their effect would have been antidilutive (in thousands):

	As of June 30,	
	2006	2005
Options to purchase common stock	4,266	3,253
Common stock subject to repurchase	14	59
Shares issuable related to the ESPP	46	38
Warrants to purchase common stock	294	70
 Total shares	 4,620	 3,420

**Note 3. Supplemental Cash Flow Data**

Supplemental cash flow data was as follows (in thousands):

	Six Months Ended		Period from
	June 30, 2006	June 30, 2005	August 5, 1997 (date of inception) to June 30, 2006
Significant non-cash investing and financing activities:			
Deferred stock-based compensation	\$	\$	\$ 6,940
Purchases of property and equipment through accounts payable	\$ 308	\$ 101	\$ 308
Purchases of property and equipment through trade in value of disposed property and equipment	\$	\$	\$ 127
Penalty on restructuring of equipment financing lines	\$	\$	\$ 475
Conversion of convertible preferred stock to common stock	\$	\$	\$ 133,172

**Note 4. Related Party Agreements***Research and Development*

In June 2006, the Company's Collaboration and License Agreement (the "Collaboration Agreement") with GlaxoSmithKline ("GSK") was amended to extend the research term for an additional year to facilitate continued research activities under an updated research plan focused towards the mitotic kinesin centromere-associated protein E ("CENP-E"). Accordingly, the research term with respect to all mitotic kinesins other than CENPE-E expired in June 2006. Under this amendment, GSK will have no obligation to reimburse the Company for its full-time employee equivalents during the extension of the research term.

In September 2005, the Collaboration Agreement was amended to provide the Company an expanded role in the development of SB-743921, a novel, small molecule inhibitor of kinesin spindle protein. SB-743921 is being developed for the treatment of cancer. Under the 2005 amendment, the Company continues to lead and fund development activities to explore the potential application of SB-743921 for the treatment of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma, subject to GSK's option to resume responsibility for development and commercialization activities for SB-743921 for these indications during a defined period. The 2005 amendment also provides for additional precommercialization payments to the Company from GSK for the achievement of certain milestones for SB-743921 and increased royalties for net sales of products containing SB-743921 under certain scenarios. GSK has the right to terminate the Collaboration Agreement on six months notice at any time. If GSK abandons development of any drug candidate prior to regulatory approval, the Company would undertake and fund the clinical development of that drug candidate or commercialization of any resulting drug, seek a new partner for such clinical development or commercialization, or curtail or abandon such clinical development or

commercialization.

*Other*

In March 2006, the Company entered into the Second Amendment to Collaboration and Facilities Agreement with Portola Pharmaceuticals, Inc. ( Portola ). Under the Collaboration and Facilities Agreement, Portola provides research and related services and access to a portion of their facilities to support such services. The First Amendment to Collaboration and Facilities Agreement entered into in March 2005 also provided for the purchase and use of certain equipment by Portola in connection with Portola providing research and related services to the Company, and the Company's reimbursement to Portola of \$285,000 for the equipment in eight quarterly payments from January 2006 through October 2007. This second amendment extends the terms of the Collaboration Agreement to December 31, 2006 and updates certain pricing and other terms and conditions. Charles J. Homcy, M.D., is the President and CEO of Portola, a member of the Company's Board of Directors and a consultant to the Company.

**Table of Contents****Note 5. Equipment Financing Lines**

In January 2006, the existing \$4.5 million equipment line of credit with GE Capital was renewed and the expiration date extended to December 31, 2006. Borrowings under the line are collateralized by associated property and equipment. In the second quarter of 2006, the Company borrowed \$1.1 million under the line to finance purchases of property and equipment. As of June 30, 2006, additional borrowings of \$1.2 million are available to the Company under this line. In connection with the line of credit, the Company is obligated to maintain a certificate of deposit with the lender (see Note 1 Organization and Summary of Significant Accounting Policies *Restricted Cash* ).

In March 2006, the Company secured a second line of credit with GE Capital of up to \$5.0 million to finance certain equipment until December 31, 2006. The line of credit is subject to the Master Security Agreement (the MSA ) between the Company and GE Capital, dated February 2001 and as amended on March 24, 2005. Under the terms of the MSA, funds borrowed by the Company from GE Capital are secured by property and equipment of the Company purchased by such borrowed funds and other collateral as agreed to by the Company. As of June 30, 2006, there is no loan balance outstanding under this line. In connection with the line of credit, the Company is obligated to maintain a certificate of deposit with the lender (see Note 1, Organization and Summary of Significant Accounting Policies *Restricted Cash* ).

**Note 6. Stockholders Equity*****Common Stock***

On January 18, 2006, the Company entered into a stock purchase agreement with certain institutional investors relating to the issuance and sale of 5,000,000 shares of our common stock at a price of \$6.60 per share, for gross offering proceeds of \$33.0 million. In connection with this offering, the Company paid an advisory fee to a registered broker-dealer of \$1.0 million. After deducting the advisory fee and the offering costs, the Company received net proceeds of approximately \$32.0 million from the offering. The offering was made pursuant to the Company s shelf registration statement on Form S-3 (SEC File No. 333-125786) filed on June 14, 2005.

In January 2006, we received proceeds of \$4.9 million from the draw down and sale of 833,537 shares of common stock pursuant to the Company s committed equity financing facility ( CEFF ) with Kingsbridge Capital Ltd. In April 2006, the Company received proceeds of \$5.6 million from the draw down and sale of 821,244 shares of common stock pursuant to our CEFF.

***Stock Option Plans******2004 Plan***

In January 2004, the Board of Directors adopted the 2004 Equity Incentive Plan (the 2004 Plan ) which was approved by the stockholders in February 2004. The 2004 Plan provides for the granting of incentive stock options, nonstatutory stock options, restricted stock purchase rights and stock bonuses to employees, directors and consultants. Under the 2004 Plan, options may be granted at prices not lower than 85% and 100% of the fair market value of the common stock on the date of grant for nonstatutory stock options and incentive stock options, respectively. Options granted to new employees generally vest 25% after one year and monthly thereafter over a period of four years. On an annual basis, the number of authorized shares automatically increases by a number of shares equal to the lesser of (i) 1,500,000 shares, (ii) 3.5% of the outstanding shares on such date, or (iii) an amount determined by the Board of Directors. Options granted to existing employees generally vest monthly over a period of four years. As of June 30, 2006, 3,801,186 shares of common stock were authorized for issuance under the 2004 Plan.

***1997 Plan***

In 1997, the Company adopted the 1997 Stock Option/Stock Issuance Plan (the 1997 Plan ). The Plan provides for the granting of stock options to employees and consultants of the Company. Options granted under the Plan may be either incentive stock options or nonstatutory stock options. Incentive stock options may be granted only to Company employees (including officers and directors who are also employees). Nonstatutory stock options may be granted to Company employees and consultants. Options under the Plan may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Board of Directors, provided, however, that (i) the exercise price of an incentive stock option and nonstatutory shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) with respect to any 10% shareholder, the exercise price of an incentive stock option or nonstatutory stock option shall not be less than



110% of the estimated fair market value of the shares on the date of grant and the term of the grant shall not exceed five years. Options may be

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exercisable immediately and are subject to repurchase options held by the Company which lapse over a maximum period of ten years at such times and under such conditions as determined by the Board of Directors. To date, options granted generally vest over four or five years (generally 25% after one year and monthly thereafter). As of June 30, 2006, the Company had reserved 1,716,096 shares of common stock for issuance related to options outstanding under the 1997 Plan and there were no shares available for future grants under the 1997 Plan.

Activity under the two stock option plans was as follows:

	<b>Options</b>		<b>Weighted</b>
	<b>Available for</b>	<b>Options</b>	<b>Average</b>
	<b>Grant</b>	<b>Outstanding</b>	<b>Exercise</b>
			<b>Price per</b>
			<b>Share</b>
Balance at December 31, 2004	1,165,114	2,644,779	\$ 3.10
Increase in authorized shares	995,861		
Options granted	(996,115)	996,115	7.23
Options exercised		(196,703)	1.48
Options forfeited	182,567	(161,958)	5.89
Balance at December 31, 2005	1,347,427	3,282,233	4.31
Options granted	(1,157,486)	1,157,486	7.10
Increase in authorized shares	1,039,881		
Options exercised		(152,833)	0.94
Options forfeited	20,626	(20,626)	6.38
Options repurchased	574		1.20
Balance at June 30, 2006	1,251,022	4,266,260	5.18

The options outstanding and currently exercisable by exercise price at June 30, 2006 were as follows:

<b>Range of Exercise Price</b>	<b>Options Outstanding</b>			<b>Vested and Exercisable</b>	
	<b>Number of</b>	<b>Weighted</b>	<b>Weighted</b>	<b>Number of</b>	<b>Weighted</b>
	<b>Options</b>	<b>Average</b>	<b>Average</b>	<b>Options</b>	<b>Average</b>
		<b>Exercise</b>	<b>Contractual</b>		<b>Exercise</b>
		<b>Price</b>	<b>Life (Years)</b>		<b>Price</b>
\$0.20 \$1.00	434,272	\$ 0.56	4.08	434,272	\$ 0.56
\$1.20	904,622	\$ 1.20	6.28	761,145	\$ 1.20
\$2.00 \$6.50	581,902	\$ 5.24	7.78	323,402	\$ 5.28
\$6.59 \$7.03	355,900	\$ 6.67	8.98	87,810	\$ 6.62
\$7.04	546,022	\$ 7.04	9.71	34,289	\$ 7.04
\$7.10	375,142	\$ 7.10	8.73	116,687	\$ 7.10
\$7.15	513,400	\$ 7.15	9.67	31,873	\$ 7.15
\$7.17 \$9.91	430,500	\$ 9.04	8.79	155,939	\$ 8.92
\$9.95 \$10.13	119,500	\$ 9.96	8.21	52,239	\$ 9.96
\$15.95	5,000	\$ 15.95	7.88	2,708	\$ 15.95
	4,266,260	\$ 5.18	7.86	2,000,364	\$ 3.35

The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 was \$4.92 per share. The total intrinsic value of options exercised during the six months ended June 30, 2006 was \$0.6 million. The aggregate intrinsic value of options outstanding and options exercisable as of June 30, 2006 was \$7.8 million and \$6.7 million, respectively. The intrinsic value is calculated as the difference between the market value as of June 30, 2006 and the exercise price of shares. The market value as of June 30, 2006 was \$6.29 as reported by Nasdaq.

***Employee Stock Purchase Plan***

In January 2004, the Board of Directors adopted the 2004 Employee Stock Purchase Plan (the ESPP ) which was approved by the stockholders in February 2004. Under the ESPP, statutory employees may purchase common stock of the Company up to a specified maximum amount through payroll deductions. The stock is purchased semi-annually at a price equal to 85% of the fair market value at certain plan-defined dates. At June 30, 2006 the Company had 1,155,451 shares of common stock reserved for issuance under the ESPP. The Company issued 95,630 shares of common stock under the ESPP in the second quarter of 2006 at a weighted average purchase price of \$4.39 per share.

**Note. 7 Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a

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company's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This Interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006. The impact of adopting FIN 48 on the Company's financial position or results of operations, if any, has not yet been determined.

**Note. 8 Subsequent Events**

On August 4, 2006 the Company entered into an agreement with Portola whereby Portola will sub-sublease approximately 2,500 square feet of office space from the Company at a monthly rate of \$1.75 per square foot. The term of the agreement commences once consent has been received from the master tenant, Millenium Pharmaceuticals, Inc., and the master landlord, Britannia Pointe Grand Limited partnership, and continues until October 31, 2006, with the option to extend on a month-to-month basis thereafter. Sublease income from this agreement will offset rent expense.

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

The discussion and analysis should be read in conjunction with our financial statements and accompanying notes included elsewhere in this report. Operating results are not necessarily indicative of results that may occur in future periods.

This document contains forward-looking statements that are based upon current expectations within the meaning of the Private Securities Reform Act of 1995. It is our intent that such statements be protected by the safe harbor created thereby. Forward-looking statements involve risks and uncertainties and our actual results and the timing of events may differ significantly from the results discussed in the forward-looking statements. Examples of such forward-looking statements include, but are not limited to, statements about or relating to:

the initiation, progress, timing, scope and anticipated date of completion of clinical trials and development for our drug candidates and potential drug candidates by ourselves, GlaxoSmithKline, or GSK, or the National Cancer Institute, or NCI, including the expected timing of initiation of various clinical trials for our drug candidates and potential drug candidates, the anticipated dates of data becoming available or being announced from various clinical trials and the anticipated timing of regulatory filings;

the exercise of our options to co-fund the development of one or both of ispinesib (formerly designated SB-715992), a drug candidate, and GSK-923295, a potential drug candidate;

the extent to which we co-fund SB-743921 for cancer indications outside of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma;

our plans or ability to develop drug candidates, such as CK-1827452, or commercialize drugs with or without a partner, including our intention to build clinical development and sales and marketing capabilities;

the potential benefits of our drug candidates and potential drug candidates;

the utility of the clinical trials programs for our drug candidates, including, but not limited to, for the treatment of cancer and heart failure;

issuance of shares of our common stock under our committed equity financing facility, or CEFF, with Kingsbridge Capital Limited, or Kingsbridge;

increasing losses, costs, expenses and expenditures;

the sufficiency of existing resources to fund our operations for at least the next 12 months;

the scope and size of research and development efforts and programs;

our ability to protect our intellectual property and avoid infringing the intellectual property rights of others;

potential competitors and potential competitive products;

anticipated operating losses, capital requirements and our needs for additional financing;

future payments under lease obligations and equipment financing lines;

expected future sources of revenue and capital;

our plans to obtain limited product liability insurance;

our plans for strategic alliances;

receipt of milestone payments and other funds from our strategic partners under strategic alliances;

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increasing the number of our employees and recruiting additional key personnel; and

expected future amortization of employee stock-based compensation.

Such forward-looking statements involve risks and uncertainties, including, but not limited to, those risks and uncertainties relating to:

difficulties or delays in development, testing, obtaining regulatory approval for, and undertaking production and marketing of our drug candidates, including decisions by GSK or the NCI to postpone or discontinue development efforts for one or more compounds or indications, or by GSK to discontinue funding of such efforts;

difficulties or delays in patient enrollment for our clinical trials;

unexpected adverse side effects or inadequate therapeutic efficacy of our drug candidates that could slow or prevent product approval (including the risk that current and past results of clinical trials or preclinical studies are not indicative of future results of clinical trials);

the receipt of funds by us under our strategic alliances;

activities and decisions of, and market conditions affecting, current and future strategic partners;

our ability to obtain additional financing if necessary;

our ability to maintain the effectiveness of current public information under our registration statement permitting resale of securities to be issued to Kingsbridge by us under, and in connection with, the CEFF;

changing standards of care and the introduction of products by competitors or alternative therapies for the treatment of indications we target;

the uncertainty of protection for our intellectual property or trade secrets, through patents or otherwise; and

potential infringement of the intellectual property rights or trade secrets of third parties.

In addition such statements are subject to the risks and uncertainties discussed in the Risk Factors section and elsewhere in this document.

When used in this Quarterly Report, unless otherwise indicated, Cytokinetics, the Company, we, our and us refer to Cytokinetics, Incorporated.

CYTOKINETICS, our logo used alone and with the mark CYTOKINETICS, and CYTOMETRIX are registered service marks and trademarks of Cytokinetics. PUMA is a trademark of Cytokinetics. Other service marks, trademarks and trade names referred to in this Quarterly Report on Form 10-Q are the property of their respective owners.

**Overview**

Cytokinetics, Incorporated is a biopharmaceutical company, incorporated in Delaware in 1997, focused on the treatment of cancer and cardiovascular disease. We currently have three novel small molecule drug candidates in clinical development and two novel small molecule potential drug candidates currently in preclinical development, including an alternative formulation of one of our current drug candidates. We anticipate one of these potential drug candidates will proceed to clinical development in 2006, and the other in 2007. Our clinical pipeline consists of two drug candidates and a potential drug candidate for the treatment of cancer, a drug candidate for the treatment of heart failure in an intravenous formulation and a potential drug candidate for the treatment of heart failure via oral administration. Our most advanced cancer drug candidate, ispinesib, is the subject of a broad Phase II clinical trials

program being conducted by our partner GSK and the NCI that is designed to evaluate its effectiveness in multiple tumor types. Currently, GSK is conducting two Phase II clinical trials evaluating the effectiveness of ispinesib in breast cancer and ovarian cancer. GSK is collaborating with the NCI to conduct five Phase II clinical trials in five other cancer indications, and the NCI is expected to



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initiate a sixth Phase II clinical trial this year. SB-743921, our second drug candidate for the treatment of cancer, is the subject of a Phase I/II clinical trial of SB-743921 in non-Hodgkin's lymphoma initiated in April of 2006. GSK-923295, our third potential drug candidate for the treatment of cancer, is currently in preclinical development under our strategic alliance with GSK. We expect that GSK will initiate Phase I clinical trials for GSK-923295 in the first half of 2007. Our drug candidate for the treatment of heart failure in an intravenous formulation, CK-1827452, entered a Phase I clinical trial in 2005. We plan to initiate a Phase II clinical trials program for this drug candidate in the second half of 2006. CK-1827452 is also currently in preclinical development as a potential drug candidate for the treatment of heart failure via oral administration. We plan to initiate an oral bioavailability Phase I clinical trial for CK-1827452 in the second half of 2006.

Since our inception in August 1997, we have incurred significant net losses. As of June 30, 2006, we had an accumulated deficit of \$199.8 million. We expect to incur substantial and increasing losses for the next several years if:

we conduct later-stage development and commercialization of ispinesib or GSK-923295 under our strategic alliance with GSK;

we advance SB-743921 through clinical development for the treatment of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma under our strategic alliance with GSK or independently;

we elect to provide a higher rate of co-funding for the development of SB-743921 for indications outside of Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma;

we exercise our option to co-fund the development of one or both of ispinesib and GSK-923295 under our strategic alliance with GSK;

we exercise our option to co-promote any of the products for which we have opted to co-fund development under our strategic alliance with GSK;

we advance our novel cardiac myosin activator, CK-1827452, through clinical development for the treatment of heart failure;

we advance other potential drug candidates into clinical trials;

we expand our research programs and further develop our proprietary drug discovery technologies; and

we elect to fund development or commercialization of any drug candidate.

Subsequent to June 30, 2006, we have obtained additional information concerning our estimated liability for certain contract research and development activities. As a result of receiving this information prior to the filing of this report on Form 10-Q, the Company has recorded additional research and development costs for the quarter ended June 30, 2006. The Company's previously announced net loss of \$13.3 million, or \$0.37 per share, for the three months ended June 30, 2006, was increased to \$13.8 million, or \$0.38 per share and the net loss announced of \$25.7 million, or \$0.73 per share, for the six months ended June 30, 2006, was increased to \$26.2 million, or \$0.74 per share.

**Oncology**

In the second quarter of 2006, in connection with our strategic alliance with GSK, we continued to make progress in advancing our oncology development program for both ispinesib and SB-743921, which are both directed to the mitotic kinesin target kinesin spindle protein, or KSP.

The oncology clinical trials program for ispinesib is a broad program that is planned to consist of nine Phase II clinical trials and six Phase I or Ib clinical trials evaluating the use of ispinesib in a variety of both solid and hematologic cancers. We believe that the breadth of this clinical trials program reflects the potential of, and the complexity of developing, a drug candidate such as ispinesib. We expect this approach should help us to identify those

tumor types that are the most promising for the continued development of ispinesib. Currently, ispinesib is being studied in seven Phase II clinical trials evaluating the safety and efficacy of ispinesib in the treatment of cancer. In addition, ispinesib is currently being studied in four Phase I or Phase Ib clinical trials evaluating the safety, tolerability and pharmacokinetics of ispinesib alone or in combination with other anti-cancer therapeutics.

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Phase II clinical trials of ispinesib, sponsored by GSK through our strategic alliance, or by the NCI are as follows:

*Non-Small Cell Lung Cancer:* GSK completed patient treatment in the platinum-sensitive arm of a two-arm, international, Phase II, open-label, monotherapy clinical trial, designed originally to enroll up to 35 patients in each arm. This clinical trial was designed to evaluate the safety and efficacy of ispinesib administered at 18mg/m<sup>2</sup> every 21 days in the second-line treatment of patients with either platinum-sensitive or platinum-refractory non-small cell lung cancer. In March 2006, we reported data from a planned interim analysis of the platinum-sensitive treatment arm of this clinical trial. In the platinum-sensitive treatment arm, ispinesib did not satisfy the criteria for advancement to Stage 2 in that treatment arm. This clinical trial was designed to require a minimum of one confirmed partial or complete response out of 20 evaluable patients in a treatment arm in order to proceed to Stage 2 in that treatment arm. The trial's primary endpoint is response rate as determined using the Response Evaluation Criteria in Solid Tumor, or RECIST, criteria. The best overall response in the platinum-sensitive treatment arm of this clinical trial was disease stabilization observed in 10 of 20 of evaluable patients, or 50%. In the overall patient population, the median time to disease progression was 6 weeks, but in the 10 patients whose best response was stable disease, median time to progression was 17 weeks. The platinum-refractory treatment arm of this clinical trial was completed in 2005. We reported data from a planned interim analysis of the platinum-refractory treatment arm of this clinical trial in September 2005. In the platinum-refractory treatment arm of this clinical trial, the pre-defined efficacy criteria required to move forward to Stage 2 were also not met.

*Breast Cancer:* GSK continues to evaluate patients in Stage 2 of a two-stage design, international, Phase II, open-label, monotherapy clinical trial, evaluating the safety and efficacy of ispinesib at 18mg/m<sup>2</sup> every 21 days in the second- or third-line treatment of patients with locally advanced or metastatic breast cancer whose disease has recurred or progressed despite treatment with anthracyclines and taxanes. The clinical trial's primary endpoint is response rate as determined using the RECIST criteria. We reported data from Stage 1 of this clinical trial in September 2005. Based on those data, the best overall responses, as determined using the RECIST criteria, were 3 confirmed partial responses observed among the first 33 evaluable patients. The most common adverse event was Grade 4 neutropenia. This clinical trial employs a Green-Dahlberg design, which requires the satisfaction of pre-defined efficacy criteria in Stage 1 to allow advancement to the Stage 2 of patient enrollment and treatment. In this clinical trial, ispinesib demonstrated sufficient anti-tumor activity to satisfy the pre-defined efficacy criteria required to move forward to the second stage. We anticipate additional data from this clinical trial in the second half of 2006.

*Ovarian Cancer:* GSK continues to conduct a Phase II, open-label, monotherapy clinical trial evaluating the efficacy of ispinesib at 18mg/m<sup>2</sup> dosed every 21 days in the second-line treatment of patients with advanced ovarian cancer previously treated with a platinum and taxane-based regimen. The primary endpoint of this clinical trial is response rate as determined by the RECIST criteria and blood serum levels of the tumor mass marker CA-125. We anticipate interim data in the second half of 2006.

*Colorectal Cancer:* The NCI has concluded enrollment of Stage 1 of a Phase II clinical trial evaluating ispinesib in the second-line treatment of patients with colorectal cancer. This open-label, monotherapy clinical trial contains two arms that evaluate different dosing schedules of ispinesib, either infused at 7 mg/m<sup>2</sup> on days 1, 8 and 15 of a 28-day schedule (Arm A) or at 18mg/m<sup>2</sup> every 21 days (Arm B). The primary endpoint is objective response as determined using the RECIST criteria. Data from this clinical trial were presented at the American Society of Clinical Oncology, or ASCO, Annual Meeting in June 2006. The presentation concluded that ispinesib did not manifest an objective response rate on either of the two schedules evaluated in heavily pretreated colorectal cancer patients. The most common Grade 3 and 4 toxicities in Arm A included neutropenia, nausea, vomiting and fatigue. The most common Grade 3 and 4 toxicity in Arm B was neutropenia, only one of which was febrile. The presentation concluded that the weekly dosing schedule in Arm A appeared to have a more favorable tolerability profile compared to the dosing schedule in Arm B.

*Hepatocellular Cancer:* The NCI has concluded enrollment of Stage 1 of a Phase II clinical trial evaluating ispinesib in the first-line treatment of patients with hepatocellular cancer. This open-label, monotherapy clinical trial evaluates ispinesib infused at 18mg/m<sup>2</sup> every 21 days. The primary endpoint is objective response as determined using the RECIST criteria. Interim data from this clinical trial are anticipated to be available in the second half of 2006.



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*Melanoma:* The NCI has concluded enrollment of Stage 1 of a Phase II clinical trial evaluating ispinesib in the first-line treatment of patients with melanoma who may have received adjuvant immunotherapy but no chemotherapy. This open-label monotherapy clinical trial evaluates ispinesib infused at 18mg/m<sup>2</sup> every 21 days. The primary endpoint is objective response as determined using the RECIST criteria. Interim data from this clinical trial are anticipated to be available in the second half of 2006.

*Head and Neck Cancer:* The NCI has concluded enrollment of Stage 1 of a Phase II clinical trial evaluating ispinesib in the first- or second-line treatment of patients with head and neck cancer. This open-label monotherapy clinical trial evaluates ispinesib infused at 18mg/m<sup>2</sup> every 21 days. The primary endpoint is objective response as determined using the RECIST criteria. Data from this clinical trial is planned to be presented at the 31<sup>st</sup> Congress of European Society for Medical Oncology in Istanbul, Turkey in September 2006.

*Prostate Cancer:* The NCI has concluded enrollment of Stage 1 of a Phase II clinical trial evaluating ispinesib in the second-line treatment of patients with hormone-refractory prostate cancer. This open-label monotherapy clinical trial evaluates ispinesib infused at 18mg/m<sup>2</sup> every 21 days. The primary endpoint is objective response as determined by blood serum levels of the tumor mass marker Prostate Specific Antigen. Interim data from this clinical trial are anticipated to be available in the second half of 2006.

In addition to these Phase II clinical trials, GSK also continues to conduct two Phase Ib clinical trials evaluating ispinesib in combination therapy. These clinical trials are both dose-escalating studies evaluating the safety, tolerability and pharmacokinetics of ispinesib, one in combination with carboplatin and the second in combination with capecitabine. Data from GSK's Phase Ib clinical trial evaluating ispinesib in combination with carboplatin was presented at the ASCO conference in June 2006 suggesting ispinesib, on a once every 21-day schedule, has an acceptable tolerability profile and no pharmacokinetic interactions when used in combination with carboplatin. At the optimally tolerated regimen, ispinesib concentrations were not affected by carboplatin. The best response was a partial response at cycle 2 in one patient with breast cancer; a total of 13 patients, or 46%, had a best response of stable disease with durations ranging from 3 to 9 months. Additional data are anticipated from GSK's Phase Ib clinical trial evaluating ispinesib in combination with capecitabine in the second half of 2006. In 2005, we and GSK presented data from two Phase Ib combination clinical trials of ispinesib at the 2005 AACR-NCI-EORTC International Meeting. These data suggest ispinesib has an acceptable tolerability profile and no pharmacokinetic interactions in patients with advanced solid tumors when used in combination with capecitabine or docetaxel. One presentation contained data from an ongoing clinical trial that demonstrated that the combination of ispinesib and capecitabine appears to have an acceptable tolerability profile on the clinical trial's treatment schedule, suggesting that these two agents have non-overlapping toxicities and therefore may be successfully combined in the treatment of certain types of cancers. The second presentation contained data from a clinical trial that demonstrated that the combination of ispinesib with docetaxel has an acceptable tolerability profile on a once every 21 day schedule. The regimen-limiting toxicity in this second clinical trial was prolonged Grade 4 neutropenia, which was consistent with the Phase I clinical trial experience with ispinesib and clinical experience with docetaxel.

The NCI also continues patient enrollment in two Phase I clinical trials designed to evaluate the safety, tolerability and pharmacokinetics of ispinesib on an alternative dosing schedule. One clinical trial is enrolling patients with advanced solid tumors who have failed to respond to all standard therapies, and the second clinical trial is enrolling patients with acute leukemia, chronic myelogenous leukemia, or advanced myelodysplastic syndromes. Data from the Phase I clinical trial evaluating an alternative dosing schedule in patients with advanced solid tumors was presented at the ASCO Meeting in June 2006 indicating the most common Grade 3 and 4 toxicities at doses ranging between 4mg/m<sup>2</sup> and 8mg/m<sup>2</sup> were neutropenia and at some doses leukopenia. As a result, 6 mg/m<sup>2</sup> was further evaluated as the potential maximum tolerated dose, or MTD. In this clinical trial, stable disease was reported in two patients with renal cell carcinoma and a minor response was noted in one patient with bladder cancer.

In addition, the NCI is planning on initiating the following open-label, monotherapy, Phase II and Phase I clinical trials of ispinesib:

*Renal Cell Cancer:* The NCI is planning on initiating a Phase II clinical trial evaluating ispinesib in the treatment of patients with renal cell cancer in the second half of 2006.

*Pediatric Solid Tumors:* The NCI is planning on initiating a Phase I clinical trial evaluating ispinesib in the treatment of pediatric patients with solid tumors in the second half of 2006.

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We expect that it will take several years before we can commercialize ispinesib, if at all. Accordingly, we cannot reasonably estimate when and to what extent ispinesib will generate revenues or material net cash flows, which may vary widely depending on numerous factors, including, but not limited to, the safety and efficacy profile of the drug, market acceptance, then-prevailing reimbursement policies, competition and other market conditions. GSK currently funds the development costs associated with ispinesib pursuant to our strategic alliance. We expect to determine whether and to what extent we will exercise our co-funding option during the conduct of our clinical trials for this drug candidate, taking into consideration clinical trial results and our business, finances and prospects at that time. If we exercise our option to co-fund certain later stage development activities associated with ispinesib, our expenditures relating to research and development of this drug candidate will increase significantly.

GSK continued to conduct a dose-escalating Phase I clinical trial evaluating the safety, tolerability and pharmacokinetics of SB-743921 in advanced cancer patients. Data from this clinical trial was presented at the ASCO Meeting in June 2006. The primary objectives of this clinical trial were to determine the dose limiting toxicities, or DLTs, and to establish the MTD of SB-743921 administered intravenously on a once every 21-day schedule; secondary objectives included assessment of the safety and tolerability of SB-743921, characterization of the pharmacokinetics of SB-743921 on this schedule and a preliminary assessment of its antitumor activity. The recommended Phase II dose of SB-743921 on the 21-day schedule is 4mg/m<sup>2</sup>, although dosing did reach 8mg/m<sup>2</sup>. The observed toxicities at the recommended Phase II dose were manageable. DLTs in this clinical trial consisted predominantly of neutropenia and elevations in hepatic enzymes and bilirubin. Disease stabilization, ranging from 9 to 45 weeks, was observed in seven patients. One patient with cholangiocarcinoma had a confirmed partial response at the MTD at cycle 10.

In April 2006, we initiated a Phase I/II clinical trial of SB-743921 in patients with non-Hodgkin's lymphoma, or NHL, in connection with an expanded development program for SB-743921 under the amendment to our Collaboration and License Agreement with GSK. This Phase I/II clinical trial is an open-label, non-randomized clinical trial designed to investigate the safety, tolerability, pharmacokinetic and pharmacodynamic profile of SB-743921 administered as a one-hour infusion on days 1 and 15 of a 28-day schedule, first without, then with the administration of granulocyte colony stimulating factor, and then to assess the potential efficacy of the MTD, of SB-743921 in patients with NHL. The clinical trials program for SB-743921 may proceed for several years, and we will not be in a position to generate any revenues or material net cash flows from this drug candidate until the program is successfully completed, regulatory approval is achieved, and a drug is commercialized. SB-743921 is at too early a stage of development for us to predict when or if this may occur.

In June 2006, we executed an amendment to our Collaboration and License Agreement with GSK whereby the research term was extended for an additional year to facilitate continued research activities under an updated research plan focused on a second mitotic kinesin and novel cancer target, centromere-associated protein E, or CENP-E. The research term under the Collaboration and License Agreement with respect to all mitotic kinesins other than CENP-E expired in June 2006. Under the 2006 amendment, GSK will have no obligation to reimburse us for full-time employee equivalents during the extension of the research term. We anticipate that GSK will file a regulatory filing for GSK-923295 in early 2007 and begin clinical trials in the first half of 2007.

GSK currently funds the development costs associated with SB-743921 outside of the indications of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. The 2005 amendment to the Collaboration and License Agreement provides for us to fund the development of SB-743921 in these hematologic cancer indications. As a result of this amendment and the co-funding of certain later-stage development activities associated with SB-743921, our expenditures relating to research and development of this drug candidate will increase significantly.

**Cardiovascular**

We have focused our cardiovascular research and development activities on heart failure, a disease most often characterized by compromised contractile function of the heart that impacts its ability to effectively pump blood throughout the body. We have discovered and optimized small molecules that improve cardiac contractility by specifically binding to and activating cardiac myosin, a cytoskeletal protein essential for cardiac muscle contraction.

In 2005, we selected a drug candidate, CK-1827452, a novel cardiac myosin activator for the treatment of heart failure, for further development in our cardiovascular program and initiated a Phase I clinical trial designed as a

double-blind, randomized, placebo-controlled, dose-escalation clinical trial to investigate the safety, tolerability, pharmacokinetics and pharmacodynamics of CK-1827452 administered intravenously to normal healthy volunteers. In June 2006, we disclosed top-line results from this clinical trial. Compared to placebo, CK-1827452, was associated with a statistically significant and clinically relevant increases in ejection fraction and fractional shortening, which are measures of cardiac function. These increases in cardiac function were associated with corresponding dose-related increases in systolic ejection time. The MTD was determined to be 0.5mg/kg/hr for the six-hour infusion



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in healthy volunteers. At the MTD, CK-1827452 was well-tolerated when compared to placebo. Across the dosing levels evaluated in this clinical trial, infusions of CK-1827452 were characterized by linear, dose-proportional pharmacokinetics and produced dose-dependent pharmacodynamic effects. The adverse effects observed at dose levels exceeding the MTD were associated with longer prolongations of systolic ejection time and larger increases in ejection fraction and fractional shortening than those that were observed with doses at or below the MTD. The adverse effects at the higher dose levels in humans appear similar to the adverse findings observed in the preclinical safety studies, which occurred at similar plasma concentrations. These effects are believed to be related to a hyper-contractile state of the myocardium and excessive prolongation of the systolic ejection time. These effects were resolved promptly with discontinuation of the infusions of CK-1827452. Additional data from the Phase I clinical trial of CK-1827452 is planned to be presented at a session entitled Recent and Late Breaking Trials at the 10<sup>th</sup> Annual Meeting of the Heart Failure Society of America in September 2006. We intend to initiate Phase II clinical trials for this drug candidate in patients with heart failure in the second half of 2006.

In 2005, we also selected CK-1827452 as a potential drug candidate for the treatment of patients with chronic heart failure via oral administration. Initiation of our Phase I oral bioavailability clinical trial is expected in the second half of 2006.

As with our drug candidates in our other programs, the compounds in our cardiovascular program, including our new drug candidate, are at too early a stage of development for us to predict if and when we will be in a position to generate any revenues or material net cash flows from any of them. We currently fund all research and development costs associated with this program. We recorded research and development expenses for activities relating to our cardiovascular program of approximately \$5.0 million and \$9.6 millions for the three and six months ended June 30, 2006, respectively, and \$4.0 million and \$8.2 million for the three and six months ended June 30, 2005. We anticipate that our expenditures relating to research and development of compounds in our cardiovascular program will increase significantly as we advance CK-1827452 through clinical development.

**Development Risks**

The successful development of all of our drug candidates is highly uncertain. We cannot estimate with certainty or know the exact nature, timing and estimated costs of the efforts necessary to complete the development of any of our drug candidates or the date of completion of these development efforts. We cannot estimate with certainty any of the foregoing due to the numerous risks and uncertainties associated with developing our drug candidates, including, but not limited to:

- the uncertainty of the timing of the initiation and completion of patient enrollment in our clinical trials;

- the possibility of delays in the collection of clinical trial data and the uncertainty of the timing of the analyses and subsequent release of our clinical trial data after such trials have been initiated and completed;

- the uncertainty of clinical trial results;

- the uncertainty of obtaining U.S. Food and Drug Administration, or FDA, or other foreign regulatory agency approval required for new therapies;

- the possibility of delays in the development, optimization and scale-up of manufacturing processes or testing and release for either the active pharmaceutical ingredient or formulated products in our cardiovascular program; and

- the uncertainty related to the development of commercial scale manufacturing processes and qualification of a commercial scale manufacturing facility.

If we fail to complete the development of any of our drug candidates in a timely manner, it could have a material adverse effect on our operations, financial position and liquidity. In addition, any failure by us or our partners to obtain, or any delay in obtaining, regulatory approvals for our drug candidates could have a material adverse effect on our results of operations. A further discussion of the risks and uncertainties associated with completing our programs

on schedule, or at all, and certain consequences of failing to do so are discussed further in the risk factors entitled "We have never generated, and may never generate, revenues from commercial sales of our drugs and we may not have drugs to market for at least several years, if ever," "Clinical trials may fail to demonstrate the desired safety and efficacy of our drug candidates, which could prevent or significantly delay completion of clinical development and regulatory approval" and "Clinical trials are expensive, time consuming and subject to delay," as well as other risk factors.

**Table of Contents****Funding**

To date, we have funded our operations primarily through the sale of equity securities, non-equity payments from GSK and AstraZeneca, equipment financings, interest on investments and government grants. We have received net proceeds from the sale of equity securities of \$261.2 million from August 5, 1997, the date of our inception, through June 30, 2006, excluding sales of equity to GSK. Included in these proceeds are \$94.0 million received upon closing of the initial public offering of our common stock in May 2004 and proceeds from our registered direct offering in January 2006 of \$32.0 million. In 2001, under our strategic alliance with GSK, GSK made a \$14.0 million upfront cash payment as well as an initial \$14.0 million equity investment. In April 2004, GSK purchased 538,461 shares of our common stock at \$13.00 per share immediately prior to the closing of our initial public offering for a total price of \$7.0 million. GSK also made a \$3.0 million equity investment in us in 2003. GSK also reimbursed certain of our full time equivalents, or FTEs, through the end of the initial five-year research term of the strategic alliance, and has committed to make additional payments upon the achievement of certain precommercialization milestones. Cumulatively as of June 30, 2006, we received \$32.0 million in FTE and other expense reimbursements and \$7.0 million in milestone payments from GSK. The research term of our Collaboration and License Agreement with AstraZeneca expired in December 2005. Cumulatively as of June 30, 2006, we received \$18.7 million under equipment financing arrangements. Interest income earned on investments, excluding amortization and accretion on investments, in the second quarter and the first six months of 2006 was \$0.7 million and \$1.4 million, respectively, and in the second quarter and first six months of 2005 was \$1.0 million and \$2.1 million, respectively.

In June 2006, the five-year research term of our strategic alliance with GSK was extended for an additional year under an updated research plan focused only on CENP-E. The research term with respect to all mitotic kinesins other than CENP-E expired on June 19, 2006. GSK is not obligated to reimburse us for research FTEs during this one year extension. GSK has agreed to fund worldwide development and commercialization of drug candidates that arise from our strategic alliance and for which GSK elects to continue in development, other than the funding for development and commercialization of SB-743921 for non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. We will earn royalties from sales of any resulting drugs. We retain product-by-product options to co-fund certain later-stage development activities, thereby potentially increasing our royalties and affording co-promotion rights in North America. If we exercise our co-promotion option, then we are entitled to receive reimbursement from GSK for certain sales force costs we incur in support of our commercial activities. GSK has the right to terminate the Collaboration and License Agreement on six months notice at any time. If GSK abandons one or more of ispinesib, SB-743921 and GSK-923295, it would delay or prevent us from commercializing such current or potential drug candidates, and would delay or prevent our ability to generate revenues. In such event, or if GSK abandons development of any drug candidate prior to regulatory approval, we would have to undertake and fund the clinical development of our drug candidates or commercialization of our drugs, seek a new partner for clinical development or commercialization, or curtail or abandon the clinical development or commercialization programs.

In October 2005, we entered into a CEFF with Kingsbridge, pursuant to which Kingsbridge committed to finance up to \$75.0 million of capital during the next three years. Subject to certain conditions and limitations, from time to time under the CEFF, at our election, Kingsbridge will purchase newly-issued shares of our common stock at a price that is between 90% and 94% of the volume weighted average price on each trading day during an eight day, forward-looking pricing period. The maximum number of shares we may issue in any pricing period is the lesser of 2.5% of our market capitalization immediately prior to the commencement of the pricing period or \$15.0 million. The minimum acceptable volume weighted average price for determining the purchase price at which our stock may be sold in any pricing period is determined by the greater of \$3.50 or 85% of the closing price for our common stock on the day prior to the commencement of the pricing period. As part of the arrangement, we issued a warrant to Kingsbridge to purchase 244,000 shares of our common stock at a price of \$9.13 per share, which represents a premium over the closing price of our common stock on the date we entered into the CEFF. This warrant is exercisable beginning six months after the date of grant and for a period of five years thereafter. The CEFF also required us to file a resale registration statement with respect to the resale of shares issued pursuant to the CEFF and underlying the warrant within 60 days of entering into the CEFF, and to use commercially reasonable efforts to have such registration statement declared effective by the Securities and Exchange Commission within 180 days of our

entry into the CEFF. Our Registration Statement on Form S-3 filed in connection with the CEFF was declared effective on December 2, 2005 (SEC File No. 333-129786). Under the terms of the CEFF, the maximum number of shares we may sell is 5,703,488 (exclusive of the shares underlying the warrant) which, under the rules of the National Association of Securities Dealers, Inc., is approximately the maximum number of shares we may sell to Kingsbridge without approval of our stockholders. This limitation may further limit the amount of proceeds we are able to obtain from the CEFF. We are not obligated to sell any of the \$75.0 million of common stock available under the CEFF and there are no minimum commitments or minimum use penalties. The CEFF does not contain any restrictions on our operating activities, any automatic pricing resets or any minimum market volume restrictions. In January 2006, we received proceeds of \$4.9 million from the draw down and sale of 833,537 shares of common stock to Kingsbridge. In April 2006, we received proceeds of \$5.6 million from the draw down and sale of 821,244 shares of common stock to Kingsbridge.

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In January 2006, we sold 5,000,000 shares of our common stock pursuant to a take down from our shelf Registration Statement on Form S-3 (SEC File No. 333-125786) to certain institutional investors at a price of \$6.60 per share, for gross offering proceeds of \$33.0 million and net offering proceeds of approximately \$32.0 million.

### **Revenues**

Our current revenue sources are limited, and we do not expect to generate any direct revenue from product sales for several years. We currently recognize revenues from our strategic alliance with GSK for contract research activities, which we record as related expenses are incurred.

Charges to GSK were based on negotiated rates intended to approximate the costs for our FTEs performing research under the strategic alliance and our out-of-pocket expenses. GSK paid us an upfront licensing fee, which we recognized ratably over the initial five-year research term of the strategic alliance, which ended in June 2006. We may receive additional payments from GSK upon achieving certain precommercialization milestones. Milestone payments are non-refundable and are recognized as revenue when earned, as evidenced by achievement of the specified milestones and the absence of ongoing performance obligations. We record amounts received in advance of performance as deferred revenue. The revenues recognized to date are not refundable, even if the relevant research effort is not successful. Because a substantial portion of our revenues for the foreseeable future will depend on achieving development and other precommercialization milestones under our strategic alliance with GSK, our results of operations may vary substantially from year to year. In the event we exercise our co-promotion option, we are entitled to receive reimbursement from GSK for certain sales force costs we incur in support of our commercial activities.

We expect that our future revenues ultimately will be derived from royalties on sales from drugs licensed to GSK under our strategic alliance and from those licensed to future partners, as well as from direct sales of our drugs. We retain a product-by-product option to co-fund certain later-stage development activities under our strategic alliance with GSK, thereby potentially increasing our royalties and affording co-promotion rights in North America.

### **Research and Development**

We incur research and development expenses associated with both partnered and unpartnered research activities, as well as the development and expansion of our drug discovery technologies. Research and development expenses relating to our strategic alliance with GSK consist primarily of costs related to research and screening, lead optimization and other activities relating to the identification of compounds for development as mitotic kinesin inhibitors for the treatment of cancer. Prior to June 2006, certain of these costs were reimbursed by GSK on an FTE basis. At this time, GSK funds the majority of the costs related to the clinical development of ispinesib. Under our 2005 amendment to the Collaboration and License Agreement with GSK, we have committed to fund certain development activities for SB-743921 for non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. We have the option to co-fund certain later-stage development activities for ispinesib and GSK-923295. This commitment and the potential exercise of any of our co-funding options will result in a significant increase research and development expenses. Research and development expenses related to any development and commercialization activities we elect to fund would consist primarily of employee compensation, supplies and materials, costs for consultants and contract research, facilities costs and depreciation of equipment. We expect to incur research and development expenses to conduct preclinical studies and clinical trials for CK-1827452 and other of our cardiac myosin activator compounds for the treatment of heart failure and in connection with our early research programs in other diseases, as well as the continued refinement of our PUMA™ system and development of our Cytometrix® technologies and our other existing and future drug discovery technologies. From our inception through June 30, 2006, we incurred costs of approximately \$51.7 million for research and development activities relating to the discovery of mitotic kinesin inhibitors, \$73.1 million for our cardiac contractility program, \$42.5 million for our proprietary technologies and \$37.2 million for all other programs.

### **General and Administrative Expenses**

General and administrative expenses consist primarily of compensation for employees in executive and administrative functions, including but not limited to finance, business and commercial development and strategic planning. Other significant costs include facilities costs and professional fees for accounting and legal services, including legal services associated with obtaining and maintaining patents. Now in our third year as a public company,

we anticipate continued increases in general and administrative expenses associated with operating as a publicly traded company, such as increased costs for insurance, investor relations and compliance with section 404 of the Sarbanes-Oxley Act of 2002.

**Table of Contents****Stock Compensation**

On January 1, 2006, we adopted Statement of Financial Accounting Standards, or SFAS, No. 123R, Share-Based Payment, which required the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases based on estimated fair values. The following table summarizes stock-based compensation related to employee stock options and employee stock purchases under SFAS No. 123R for the three and six months ended June 30, 2006, which was allocated as follows (in thousands):

	<b>Three Months Ended June 30, 2006</b>	<b>Six Months Ended June 30, 2006</b>
Research and development	\$ 679	\$ 1,235
General and administrative	738	1,120
Stock-based compensation included in operating expenses	\$ 1,417	\$ 2,355

As of June 30, 2006, there was \$9.0 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 3.17 years. In addition, we continue to amortize deferred stock-based compensation recorded prior to adoption of SFAS No. 123R for stock options granted prior to the initial public offering. At June 30, 2006, the balance of deferred stock based compensation was \$1.8 million. We expect the remaining balance of deferred employee stock-based compensation of \$1.8 million as of June 30, 2006 to be amortized in future years as follows, assuming no cancellations of the related stock options: \$0.6 million in the remainder of 2006, \$0.8 million in 2007 and \$0.4 million in 2008.

**Interest and Other Income and Expense**

Interest and other income and expense consist primarily of interest income and interest expense. Interest income is generated primarily from investment of our cash, cash equivalents and investments. Interest expense generally relates to the borrowings under our equipment financing lines.

**Results of Operations****Revenues**

We recorded total revenues of \$1.4 million and \$2.9 million in the second quarter and first six months of 2006, respectively, compared with total revenues of \$2.3 million and \$4.9 million in the second quarter and first six months of 2005, respectively. The decrease in revenues for the second quarter and six months ended June 30, 2006, compared to the same periods in 2005, was primarily due to reductions in FTE and patent reimbursement revenue from GSK of approximately \$0.6 million and \$1.4 million, respectively, and a reduction in collaboration revenue from AstraZeneca of approximately \$0.3 million and \$0.6 million, respectively.

Research and development revenues from a related party refers to revenues from our strategic partner, GSK, which is also a stockholder of the Company. Research and development revenues from GSK were approximately \$0.7 million and \$1.5 million in the second quarter and first six months of 2006, respectively, and \$1.3 million and \$2.9 million in the second quarter and first six months of 2005, respectively. The decrease in the second quarter of 2006, compared with 2005, was primarily due to a \$0.5 million decrease in FTE reimbursements and a \$0.1 million decrease in patent expense reimbursements by GSK. Prior to the June 2006 amendment to our Collaboration and License Agreement with GSK, the FTE reimbursement level was determined annually by GSK and us, in accordance with the annual research plan and contractually predefined minimum FTE support levels. In June 2006, the five-year research term of our strategic alliance with GSK was extended for an additional year under an updated research plan focused only on CENP-E without corresponding FTE reimbursement.

License revenues from related party represents license revenue from our strategic alliance with GSK. License revenue was \$0.7 million and \$1.4 million for the second quarter and first six months ended June 30, 2006 and 2005. The license revenue is being amortized on a straight line basis over the initial five-year research term. As of June 30, 2006, there is no remaining balance of deferred revenue.





**Table of Contents****Research and Development Expenses**

Research and development expenses increased to \$12.4 million and \$23.7 million in the second quarter and first six months of 2006, respectively, from \$10.0 million and \$20.6 million in the second quarter and first six months of 2005, respectively. The increases in spending in the second quarter and first six months of 2006 as compared to the same periods of 2005 were primarily due to the manufacture of clinical supply and other clinical outsourcing costs as we advanced our drug candidates for the treatment of cardiovascular disease and cancer through clinical trials and higher expense related to compensation and benefits, including charges for stock-based compensation.

From a program perspective, the increases in spending in the second quarter and first six months of 2006, compared to the same periods in 2005, were primarily due to higher expenditures related to the advancement of our cardiac contractility program of approximately \$1.0 million and \$1.4 million, respectively, and early research programs of approximately \$2.4 million and \$3.4 million, respectively. The increases were slightly offset by decreased spending on oncology in the second quarter and first six months of 2006 of approximately \$0.7 million and \$0.8 million, respectively, and proprietary technologies of approximately \$0.3 million and \$0.9 million, respectively.

Research and development expenses incurred related to the following programs (in millions):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>30,</b>	<b>30,</b>	<b>30,</b>	<b>30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Mitotic kinesin inhibitors	\$ 1.4	\$ 2.1	\$ 3.3	\$ 4.1
Cardiac contractility	5.0	4.0	9.6	8.2
Proprietary technologies	1.2	1.5	2.4	3.3
All other research programs	4.8	2.4	8.4	5.0
Total research and development expenses	\$ 12.4	\$ 10.0	\$ 23.7	\$ 20.6

Clinical timelines, likelihood of success and total completion costs vary significantly for each drug candidate and are difficult to estimate. We anticipate that we will make determinations as to which research programs to pursue and how much funding to direct to each program on an ongoing basis in response to the scientific and clinical success of each drug candidate. The lengthy process of seeking regulatory approvals and subsequent compliance with applicable regulations requires the expenditure of substantial resources. Any failure by us to obtain, or any delay in obtaining, regulatory approvals could cause our research and development expenditures to increase and, in turn, could have a material adverse effect on our results of operations.

We expect research and development expenditures to continue to increase in 2006 and beyond as we advance research and development for our drug candidate CK-1827452 and continue our clinical trial of SB-743921 under our strategic alliance with GSK. In addition, research and development expenditures will increase significantly if we exercise our option to co-fund certain later-stage research and development activities relating to ispinesib or GSK-923295.

**General and Administrative Expenses**

General and administrative expenses increased to \$3.9 million and \$7.6 million in the second quarter and first six months of 2006, respectively compared with \$3.4 million and \$6.5 million for the second quarter and first six months of 2005, respectively. The increases in spending in the second quarter and first six months of 2006 as compared to the same periods of 2005 were primarily due to higher compensation and benefits expenses, including charges for stock-based compensation, which were partially offset by lower legal fees and consulting expenses.

We expect that general and administrative expenses will continue to increase during the remainder of 2006 and beyond due to increasing payroll related expenses in support of our initial precommercialization efforts, business development costs, our expanding operational infrastructure, compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, expenses resulting from our adoption of SFAS No. 123R and other costs associated with being a public company.

***Interest and Other Income and Expense***

Interest and other income was \$1.2 million and \$2.4 million, respectively, for the second quarter and first six months of 2006, compared with \$0.7 million and \$1.4 million in the second quarter and first six months of 2005, respectively. The increase in the second quarter and first six months of 2006 over the comparable periods in 2005 were attributable to higher interest yields resulting from higher market interest rates earned on our invested cash.

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Interest and other expense in the second quarter and first six months of 2006 were \$0.1 million and \$0.2 million, respectively, compared with \$0.1 million and \$0.3 million in the second quarter and first six months of 2005, respectively. Interest and other expense in each of these periods primarily consisted of interest expense on our equipment financing line of credit.

**Critical Accounting Policies**

The accounting policies that we consider to be our most critical (those that are most important to the portrayal of our financial condition and results of operations and that require our most difficult, subjective or complex judgments), the effects of those accounting policies applied and the judgments made in their application are summarized in *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005. As a result of our adoption of SFAS No. 123R during the first quarter of 2006, we also consider our accounting policy relating to stock-based compensation, which is set forth in Note 1 to the Unaudited Condensed Financial Statements and summarized below, to be critical.

***Stock-Based Compensation***

Effective January 1, 2006 we adopted SFAS No. 123R using the modified prospective transition method for awards granted subsequent to our initial public offering, or IPO, and the prospective transition method for awards granted prior to our IPO. Prior periods are not revised for comparative purposes under either transition method. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award.

We currently use the Black-Scholes option pricing model to determine the fair value of stock options and employee stock purchase plan shares. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. The variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends, if any.

We estimate the expected term of options granted by taking the average of the vesting term and the contractual term of the options, referred to as the simplified method in accordance with Staff Accounting Bulletin No. 107, Share-Based Payment. We estimate the volatility of our common stock by using an average of historical stock price volatility of comparable companies. We base the risk-free interest rate that we use in the option pricing model on the U.S. Treasury zero-coupon issues with remaining terms similar to the expected terms on the options. We do not anticipate paying dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option pricing model. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting options forfeitures and record stock-based compensation expense only on those awards that are expected to vest. All share-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period.

We continue to amortize deferred stock-based compensation recorded prior to adoption of SFAS No. 123R for stock options granted prior to our IPO. Fair value of these awards has been calculated at grant date using the intrinsic value method as prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees.

**Liquidity and Capital Resources**

From August 5, 1997, our date of inception, through June 30, 2006, we funded our operations through the sale of equity securities, equipment financings, non-equity payments from collaborators, government grants and interest income.

Our cash, cash equivalents and investments, excluding restricted cash, totaled \$94.9 million at June 30, 2006 compared with \$76.2 million at December 31, 2005. The increase primarily represents proceeds from the issuance of common stock related to our registered direct offering in January 2006 and to a lesser extent the draw downs under our CEFF with Kingsbridge, partly offset by the use of proceeds from investment maturities to fund operations.



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Net cash used in operating activities in the first six months of 2006 was \$22.3 million and was primarily due to a net loss of \$25.7 million. This compares with net cash used in operating activities of \$20.6 million, and a net loss of \$21.1 million, in the first six months of 2005.

Net cash provided by investing activities was \$15.7 million in the first six months of 2006 and represented primarily the proceeds from the sales and maturities of investments, net of purchase of investments. Restricted cash totaled \$5.1 million at June 30, 2006 and \$5.2 million at December 31, 2005. The balance decreased because our equipment financing lender has required a lower security deposit in 2006.

Net cash provided by financing activities of \$42.9 million in the first six months of 2006 represented proceeds from the issuance and sale of common stock, slightly offset by the net repayments of our equipment financing line. In January 2006, we sold 5,000,000 shares of our common stock to certain institutional investors at a price of \$6.60 per share, for gross offering proceeds of \$33.0 million and net offering proceeds of approximately \$32.0 million. In the first six months of 2006, we received proceeds of \$10.6 million from the draw down and sale of 1,654,781 shares of common stock to Kingsbridge.

In January 2006, the existing \$4.5 million equipment line of credit with General Electric Capital Corporation, or GE Capital, was renewed and the expiration date extended to December 31, 2006. We have made \$1.1 million in additional borrowings under the line in the current quarter. As of June 30, 2006, additional borrowings of \$1.2 million are available to us under the line. In March 2006, we secured a second line of credit with GE Capital of up to \$5.0 million to finance certain equipment until December 31, 2006. As of June 30, 2006, there is no loan balance outstanding under this line. Both equipment lines are subject to the Master Security Agreement, or MSA, between us and GE Capital, dated February 2001 as amended on March 24, 2005. Under the terms of the MSA, funds borrowed by us from GE Capital are collateralized by our property and equipment purchased by such borrowed funds and other collateral as agreed to by us. In connection with each line of credit, we are obligated to maintain a certificate of deposit with the lender.

As of June 30, 2006, future minimum payments under lease obligations and equipment financing lines were as follows (in thousands):

	<b>Within One Year</b>	<b>Two to Three Years</b>	<b>Four to Five Years</b>	<b>After Five Years</b>	<b>Total</b>
Operating leases	\$ 2,619	\$ 5,658	\$ 5,742	\$ 4,210	\$ 18,229
Equipment financing line	2,990	5,104	1,032		9,126
Total	\$ 5,609	\$ 10,762	\$ 6,774	\$ 4,210	\$ 27,355

Our long-term commitments under operating leases relate to payments under our two facility leases in South San Francisco, California, which expire in 2011 and 2013.

Under the provisions of our amended agreement with Portola Pharmaceuticals, Inc., or Portola, we are obligated to reimburse Portola for certain equipment costs incurred by Portola in connection with research and related services that Portola provides to us. We began to incur these costs when the equipment became available for use in the second quarter of 2005. Our payments to Portola for such equipment costs, totaling \$285,000, are scheduled to be made in eight quarterly installments commencing in the first quarter of 2006 and continuing through the fourth quarter of 2007.

We expect to incur substantial costs as we continue to expand our research programs and related research and development activities. Under the terms of our strategic alliance with GSK, we have options to co-fund certain later-stage development activities for ispinesib. We have committed to fund certain later-stage development activities for SB-743921 for non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. In addition, we have committed to co-fund certain later-stage development activities for SB-743921 for cancer indications outside of these hematologic indications. This commitment and the potential exercise of any of our co-funding options will result in a significant increase in research and development expenses. We expect to determine whether and to what extent we

will exercise our co-funding options based on clinical results and our business, finances and prospects at the time we receive the Phase II clinical trial results for each drug candidate under our strategic alliance with GSK. Research and development expenses for our unpartnered drug discovery programs consist primarily of employee compensation, supplies and materials, costs for consultants and contract research and development, facilities costs and depreciation of equipment. We expect to incur significant research and development expenses as we advance the research and development of our cardiac myosin activators for the treatment of heart failure, continue clinical trials of CK-1827452 and SB-743921 in 2006, pursue our other early stage research programs in multiple therapeutic areas, refine our PUMA<sup>™</sup> system and develop Cytometrix® technologies and other proprietary drug discovery technologies.

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Our future capital uses and requirements depend on numerous forward-looking factors. These factors include, but are not limited to, the following:

the initiation, progress, timing, scope and completion of preclinical research, development and clinical trials for our drug candidates and potential drug candidates;

the time and costs involved in obtaining regulatory approvals;

delays that may be caused by requirements of regulatory agencies;

GSK's decisions with regard to continued funding of research and development of our drug candidates;

our level of funding for other current or future drug candidates, including CK-1827452 for the treatment of heart failure;

our level of funding for SB-743921 for the treatment of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma;

our options to co-fund the development of ispinesib and GSK-923295;

our level of co-funding for the development of SB-743921 for cancer indications other than Hodgkin's lymphoma, non-Hodgkin's lymphoma and multiple myeloma;

the number of drug candidates we pursue;

the costs involved in filing and prosecuting patent applications and enforcing or defending patent claims;

our ability to establish, enforce and maintain selected strategic alliances and activities required for commercialization of our potential drugs;

our plans or ability to establish sales, marketing or manufacturing capabilities and to achieve market acceptance for potential drugs;

expanding and advancing our research programs;

hiring of additional employees and consultants;

expanding our facilities;

the acquisition of technologies, products and other business opportunities that require financial commitments; and

our revenues, if any, from successful development of our drug candidates and commercialization of potential drugs.

We believe that our existing cash and cash equivalents, proceeds from our January 2006 offering of common stock, future payments from GSK, interest earned on investments, proceeds from equipment financings and the potential proceeds from the CEFF will be sufficient to meet our projected operating requirements for at least the next 12 months. If, at any time, our prospects for internally financing our research and development programs decline, we may decide to reduce research and development expenses by delaying, discontinuing or reducing our funding of development of one or more of our drug candidates or potential drug candidates. Alternatively, we might raise funds

through public or private financings, strategic relationships or other arrangements. We cannot assure you that the funding, if needed, will be available on attractive terms, or at all. Furthermore, any additional equity financing may be dilutive to stockholders and debt financing, if available, may involve restrictive covenants. Similarly, financing obtained through future co-development arrangements may require us to forego certain commercial rights to future drug candidates. Our failure to raise capital as and when needed could have a negative impact on our financial condition and our ability to pursue our business strategy.



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**Off-balance Sheet Arrangements**

As of June 30, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. Therefore, we are not materially exposed to financing, liquidity, market or credit risk that could arise if we had engaged in these relationships. We do not have relationships or transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our exposure to market risk has not changed materially subsequent to our disclosures in Item 7A, Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2005.

**ITEM 4. CONTROLS AND PROCEDURES**

**(a) Evaluation of disclosure controls and procedures**

Our management evaluated, with the participation and under the supervision of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded, subject to the limitations described below, that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures.

**(b) Changes in internal control over financial reporting**

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**(c) Limitations on the Effectiveness of Controls**

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the controls are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

*Our future operating results may vary substantially from anticipated results due to a number of factors, many of which are beyond our control. The following discussion highlights some of these factors and the possible impact of these factors on future results of operations. You should carefully consider these factors before making an investment decision. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our common stock could decline, and you could experience losses on your investment.*

**Risks Related To Our Business**

***Our drug candidates are in the early stages of clinical testing and we have a history of significant losses and may not achieve or sustain profitability and, as a result, you may lose all or part of your investment.***

Our drug candidates are in the early stages of clinical testing and we must conduct significant additional clinical trials before we can seek the regulatory approvals necessary to begin commercial sales of our drugs. We have incurred operating losses in each year since our inception in 1997 due to costs incurred in connection with our research and development activities and general and administrative costs associated with our operations. We expect to incur increasing losses for at least several years, as we continue our research activities and conduct development of, and seek regulatory approvals for, our drug candidates, and commercialize any approved drugs. If our drug candidates fail in clinical trials or do not gain regulatory approval, or if our drugs do not achieve market acceptance, we will not be profitable. If we fail to become and remain profitable, or if we are unable to fund our continuing losses, you could lose all or part of your investment.

***We have never generated, and may never generate, revenues from commercial sales of our drugs and we may not have drugs to market for at least several years, if ever.***

We currently have no drugs for sale and we cannot guarantee that we will ever have marketable drugs. We must demonstrate that our drug candidates satisfy rigorous standards of safety and efficacy to the U.S. Food and Drug Administration, or FDA, and other regulatory authorities in the United States and abroad. We and our partners will need to conduct significant additional research and preclinical and clinical testing before we or our partners can file applications with the FDA or other regulatory authorities for approval of our drug candidates. In addition, to compete effectively, our drugs must be easy to use, cost-effective and economical to manufacture on a commercial scale, compared to other therapies available for the treatment of the same conditions. We may not achieve any of these objectives. Ispinesib, our most advanced drug candidate for the treatment of cancer, SB-743921, our second drug candidate for the treatment of cancer, and CK-1827452 in an intravenous form, our drug candidate for the treatment of heart failure, are currently our only drug candidates in clinical trials and we cannot be certain that the clinical development of these or any other drug candidate in preclinical testing or clinical development will be successful, that they will receive the regulatory approvals required to commercialize them, or that any of our other research programs will yield a drug candidate suitable for entry into clinical trials. Our commercial revenues, if any, will be derived from sales of drugs that we do not expect to be commercially available for several years, if at all. The development of any one or all of these drug candidates may be discontinued at any stage of our clinical trials programs and we may not generate revenue from any of these drug candidates.

***We currently finance and plan to continue to finance our operations through the sale of equity, incurring debt and potentially entering into additional strategic alliances, which may result in additional dilution to our stockholders, restriction of our business activities or relinquishment of valuable technology rights, or may cease to be available on attractive terms or at all.***

We have funded all of our operations and capital expenditures with proceeds from both private and public sales of our equity securities, strategic alliances with GSK, AstraZeneca and others, equipment financings, interest on investments and government grants. We believe that our existing cash and cash equivalents, future payments from GSK, interest earned on investments, proceeds from equipment financings and potential proceeds from our CEFF with Kingsbridge will be sufficient to meet our projected operating requirements for at least the next 12 months. To meet

our future cash requirements, we may raise funds through public or private equity offerings, debt financings or strategic alliances. To the extent that we raise additional funds by issuing equity securities, our

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stockholders may experience additional dilution. To the extent that we raise additional funds through debt financing, if available, such financing may involve covenants that restrict our business activities. To the extent that we raise additional funds through strategic alliance and licensing arrangements, we will likely have to relinquish valuable rights to our technologies, research programs or drug candidates, or grant licenses on terms that may not be favorable to us. In addition, we cannot assure you that any such funding, if needed, will be available on attractive terms, or at all.

***Clinical trials may fail to demonstrate the desired safety and efficacy of our drug candidates, which could prevent or significantly delay completion of clinical development and regulatory approval.***

Prior to receiving approval to commercialize any of our drug candidates, we must demonstrate with substantial evidence from well-controlled clinical trials, and to the satisfaction of the FDA and other regulatory authorities in the United States and abroad, that such drug candidate is both sufficiently safe and effective. In clinical trials we will need to demonstrate efficacy for the treatment of specific indications and monitor safety throughout the clinical development process. None of our drug candidates have yet demonstrated long-term safety and efficacy in clinical trials. In addition, for each of our current preclinical compounds, we must demonstrate satisfactory chemistry, formulation, stability and toxicity in order to file an investigational new drug application, or IND, or a foreign equivalent, that would allow us to advance that compound into clinical trials. If our preclinical studies, current clinical trials or future clinical trials are unsuccessful, our business and reputation will be harmed and our stock price will be negatively affected.

All of our drug candidates are prone to the risks of failure inherent in drug development. Preclinical studies may not yield results that would satisfactorily support the filing of an IND (or a foreign equivalent) with respect to our potential drug candidates, and, even if these applications would be or have been filed with respect to our drug candidates, the results of preclinical studies do not necessarily predict the results of clinical trials. Similarly, early-stage clinical trials do not predict the results of later-stage clinical trials, including the safety and efficacy profiles of any particular drug candidate. In addition, there can be no assurance that the design of our clinical trials is focused on appropriate tumor types, patient populations, dosing regimens or other variables which will result in obtaining the desired efficacy data to support regulatory approval to commercialize the drug. Even if we believe the data collected from clinical trials of our drug candidates are promising, such data may not be sufficient to support approval by the FDA or any other U.S. or foreign regulatory authority. Preclinical and clinical data can be interpreted in different ways. Accordingly, FDA officials or officials from foreign regulatory authorities could interpret the data in different ways than we or our partners do, which could delay, limit or prevent regulatory approval.

Administering any of our drug candidates or potential drug candidates that are the subject of preclinical studies to animals may produce undesirable side effects, also known as adverse effects. Toxicities and adverse effects that we have observed in preclinical studies for some compounds in a particular research and development program may occur in preclinical studies or clinical trials of other compounds from the same program. Such toxicities or adverse effects could delay or prevent the filing of an IND (or a foreign equivalent) with respect to such drug candidates or potential drug candidates or cause us to cease clinical trials with respect to any drug candidate. In clinical trials of ispinesib, the dose-limiting toxicity was neutropenia, a decrease in the number of a certain type of white blood cell that results in an increase in susceptibility to infection. In a Phase I clinical trial of SB-743921, the dose-limiting toxicities observed to date were: prolonged neutropenia, with or without fever and with or without infection; elevated transaminases and hyperbilirubinemia, both of which are abnormalities of liver function; and hyponatremia, which is a low concentration of sodium in the blood. In clinical trials, administering any of our drug candidates to humans may produce adverse effects. In a Phase I clinical trial of CK-1827452, doses that exceeded the MTD of CK-1827452 were associated with longer prolongations of systolic ejection time and larger increases in ejection fraction and fractional shortening than those that were observed with doses at or below MTD. These effects are believed to be related to a hyper-contractile state of the myocardium and excessive prolongation of the systolic ejection time. These effects were resolved promptly with discontinuance of infusions of CK-1827452. These adverse effects could interrupt, delay or halt clinical trials of our drug candidates and could result in the FDA or other regulatory authorities denying approval of our drug candidates for any or all targeted indications. The FDA, other regulatory authorities, our partners or we may suspend or terminate clinical trials at any time. Even if one or more of our drug candidates were approved for sale, the

occurrence of even a limited number of toxicities or adverse effects when used in large populations may cause the FDA to impose restrictions on, or stop, the further marketing of such drugs. Indications of potential adverse effects or toxicities which may occur in clinical trials and which we believe are not significant during the course of such clinical trials may later turn out to actually constitute serious adverse effects or toxicities when a drug has been used in large populations or for extended periods of time. Any failure or significant delay in completing preclinical studies or clinical trials for our drug candidates, or in receiving and maintaining regulatory approval for the sale of any drugs resulting from our drug candidates, may severely harm our reputation and business.

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***Clinical trials are expensive, time consuming and subject to delay.***

Clinical trials are very expensive and difficult to design and implement, especially in the cancer and heart failure indications that we are pursuing, in part because they are subject to rigorous requirements. The clinical trial process is also time consuming. According to industry studies, the entire drug development and testing process takes on average 12 to 15 years, and the fully capitalized resource cost of new drug development averages approximately \$800 million. However, individual clinical trials and individual drug candidates may incur a range of costs or time demands above or below this average. We estimate that clinical trials of our most advanced drug candidates will continue for several years, but they may take significantly longer to complete. The commencement and completion of our clinical trials could be delayed or prevented by many factors, including, but not limited to:

delays in obtaining regulatory approvals to commence a clinical trial;

delays in identifying and reaching agreement on acceptable terms with prospective clinical trial sites;

slower than expected rates of patient recruitment and enrollment, including as a result of the introduction of alternative therapies or drugs by others;

lack of effectiveness during clinical trials;

unforeseen safety issues;

inadequate supply of clinical trial material;

uncertain dosing issues;

introduction of new therapies or changes in standards of practice or regulatory guidance that render our clinical trial endpoints or the targeting of our proposed indications obsolete;

inability to monitor patients adequately during or after treatment; and

inability or unwillingness of medical investigators to follow our clinical protocols.

We do not know whether planned clinical trials will begin on time, or whether planned or currently ongoing clinical trials will need to be restructured or will be completed on schedule, if at all. Significant delays in clinical trials will impede our ability to commercialize our drug candidates and generate revenue and could significantly increase our development costs.

***We depend on GSK for the conduct, completion and funding of the clinical development and commercialization of our current drug candidates for the treatment of cancer.***

Under our strategic alliance with GSK, as amended, GSK is currently responsible for the clinical development and regulatory approval of our drug candidate ispinesib and our potential drug candidate GSK-923295 for all cancer indications, and for our drug candidate SB-743921 for all cancer indications except non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. Other than our right to file INDs (or the foreign equivalent) for SB-743921 for these three hematologic cancer indications, GSK is responsible for filing applications with the FDA or other regulatory authorities for approval of these drug candidates and our potential drug candidate and will be the owner of any marketing approvals issued by the FDA or other regulatory authorities. If the FDA or other regulatory authorities approve these drug candidates, GSK will also be responsible for the marketing and sale of these drugs including, at their option, SB-743921 for non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. Because GSK is responsible for these functions, we cannot control whether GSK will devote sufficient attention and resources to the clinical trials program or will proceed in an expeditious manner. GSK generally has discretion to elect whether to pursue the development of our drug candidates or to abandon the clinical trial programs, and may terminate our strategic alliance for any reason upon six months prior notice. These decisions are outside our control.

Two of our cancer drug candidates being developed by GSK act through inhibition of KSP, a member of a class of cytoskeletal proteins that regulate cell division called mitotic kinesins. Because these drug candidates have similar mechanisms of action, GSK may elect to proceed with the development of only one such drug candidate. If GSK were to elect to proceed with the development of SB-743921 in lieu of ispinesib, because SB-743921 is at an earlier stage of clinical development than ispinesib, the approval, if any, of a new drug application, or NDA, with respect to a drug candidate from our cancer program would be delayed. In particular, if the

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initial clinical results of some of our early clinical trials do not meet GSK's expectations, GSK may elect to terminate further development of one or both drug candidates or certain of the ongoing clinical trials for drug candidates, even though the actual number of patients that have been treated is relatively small. Furthermore, GSK may elect to terminate one or more clinical trials for ispinesib at any time for some or all indications, including indications which GSK previously determined to advance to the next stage of patient enrollment, such as the ongoing breast cancer clinical trial, even though such clinical trial may not yet have been completed and regardless of clinical activity that may have been demonstrated.

If GSK abandons one or more of ispinesib, SB-743921 and GSK-923295, it would result in a delay in or prevent us from commercializing such current or potential drug candidates, and would delay or prevent our ability to generate revenues. Disputes may arise between us and GSK, which may delay or cause termination of any clinical trials program, result in significant litigation or arbitration, or cause GSK to act in a manner that is not in our best interest. If development of our current and potential drug candidates does not progress for these or any other reasons, we would not receive further milestone payments from GSK. Even if the FDA or other regulatory agencies approve one or more of our drug candidates, GSK may elect not to proceed with the commercialization of such drugs, or may elect to pursue commercialization of one drug but not others, and these decisions are outside our control. In such event, or if GSK abandons development of any drug candidate prior to regulatory approval, we would have to undertake and fund the clinical development of our drug candidates or commercialization of our drugs, seek a new partner for clinical development or commercialization, or curtail or abandon the clinical development or commercialization programs. If we were unable to do so on acceptable terms, or at all, our business would be harmed, and the price of our common stock would be negatively affected.

***If we fail to enter into and maintain successful strategic alliances for certain of our drug candidates, we may have to reduce or delay our drug candidate development or increase our expenditures.***

Our strategy for developing, manufacturing and commercializing certain of our drug candidates currently requires us to enter into and successfully maintain strategic alliances with pharmaceutical companies or other industry participants to advance our programs and reduce our expenditures on each program. We have formed a strategic alliance with GSK with respect to ispinesib, SB-743921, GSK-923295 and certain other research activities. However, we may not be able to negotiate additional strategic alliances on acceptable terms, if at all. If we are not able to maintain our existing strategic alliances or establish and maintain additional strategic alliances, we may have to limit the size or scope of, or delay, one or more of our drug development programs or research programs or undertake and fund these programs ourselves. If we elect to increase our expenditures to fund drug 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.

***The success of our development efforts depends in part on the performance of our partners and the NCI, over which we have little or no control.***

Our ability to commercialize drugs that we develop with our partners and that generate royalties from product sales depends on our partners' abilities to assist us in establishing the safety and efficacy of our drug candidates, obtaining and maintaining regulatory approvals and achieving market acceptance of the drugs once commercialized. Our partners may elect to delay or terminate development of one or more drug candidates, independently develop drugs that could compete with ours or fail to commit sufficient resources to the marketing and distribution of drugs developed through their strategic alliances with us. Our partners may not proceed with the development and commercialization of our drug candidates with the same degree of urgency as we would because of other priorities they face. In particular, we are relying on the NCI to conduct several important clinical trials of ispinesib. The NCI is a government agency and there can be no assurance that the NCI will not modify its plans to conduct such clinical trials or will proceed with such clinical trials diligently. We have no control over the conduct of clinical trials being conducted by the NCI, including the timing of initiation, termination or completion of such clinical trials, the analysis of data arising out of such clinical trials or the timing of release of complete data concerning such clinical trials, which may impact our ability to report on their results. If our partners fail to perform as we expect, our potential for revenue from drugs developed through our strategic alliances, if any, could be dramatically reduced.





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***Our focus on the discovery of drug candidates directed against specific proteins and pathways within the cytoskeleton is unproven, and we do not know whether we will be able to develop any drug candidates of commercial value.***

We believe that our focus on drug discovery and development directed at the cytoskeleton is novel and unique. While a number of commonly used drugs and a growing body of research validate the importance of the cytoskeleton in the origin and progression of a number of diseases, no existing drugs specifically and directly interact with the cytoskeletal proteins and pathways that our drug candidates seek to modulate. As a result, we cannot be certain that our drug candidates will appropriately modulate the targeted cytoskeletal proteins and pathways or produce commercially viable drugs that safely and effectively treat cancer, heart failure or other diseases, or that the results we have seen in preclinical models will translate into similar results in humans. In addition, even if we are successful in developing and receiving regulatory approval for a commercially viable drug for the treatment of one disease focused on the cytoskeleton, we cannot be certain that we will also be able to develop and receive regulatory approval for drug candidates for the treatment of other forms of that disease or other diseases. If we or our partners fail to develop and commercialize viable drugs, we will not achieve commercial success.

***Our proprietary rights may not adequately protect our technologies and drug candidates.***

Our commercial success will depend in part on our obtaining and maintaining patent and trade secret protection of our technologies and drug candidates as well as successfully defending these patents against third-party challenges. We will only be able to protect our technologies and drug candidates from unauthorized use by third parties to the extent that valid and enforceable patents or trade secrets cover them. In the event that our issued patents and our patent applications, if granted, do not adequately describe, enable or otherwise provide coverage of our technologies and drug candidates, including for example ispinesib, SB-743921, GSK-923295 and CK-1827452, we would not be able to exclude others from developing or commercializing these drug candidates and potential drug candidates. Furthermore, the degree of future protection of our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage.

The patent positions of life sciences companies can be highly uncertain and involve complex legal and factual questions for which important legal principles remain unresolved. No consistent policy regarding the breadth of claims allowed in such companies' patents has emerged to date in the United States. The patent situation outside the United States is even more uncertain. Changes in either the patent laws or in interpretations of patent laws in the United States or other countries may diminish the value of our intellectual property. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents. For example:

we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications and issued patents;

we or our licensors might not have been the first to file patent applications for these inventions;

others may independently develop similar or alternative technologies or duplicate any of our technologies without infringing our intellectual property rights;

Some or all of our or our licensors' pending patent applications may not result in issued patents;

our and our licensors' issued patents may not provide a basis for commercially viable drugs or therapies, or may not provide us with any competitive advantages, or may be challenged and invalidated by third parties;

our or our licensors' patent applications or patents may be subject to interference, opposition or similar administrative proceedings;

we may not develop additional proprietary technologies or drug candidates that are patentable; or

the patents of others may prevent us or our partners from discovering, developing or commercializing our drug candidates.

We also rely on trade secrets to protect our technology, especially where we believe patent protection is not appropriate or obtainable. However, trade secrets are difficult to protect. While we use reasonable efforts to protect our trade secrets, our or our strategic partners' employees, consultants, contractors or scientific and other advisors may unintentionally or willfully disclose our information to competitors. In addition, confidentiality agreements, if any, executed by such persons may not be enforceable or

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provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure. If we were to enforce a claim that a third party had illegally obtained and was using our trade secrets, our enforcement efforts would be expensive and time consuming, and the outcome would be unpredictable. In addition, courts outside the United States are sometimes less willing to protect trade secrets. Moreover, if our competitors independently develop information that is equivalent to our trade secrets, it will be more difficult for us to enforce our rights and our business could be harmed.

If we are not able to defend the patent or trade secret protection position of our technologies and drug candidates, then we will not be able to exclude competitors from developing or marketing competing drugs, and we may not generate enough revenue from product sales to justify the cost of development of our drugs and to achieve or maintain profitability.

***If we are sued for infringing intellectual property rights of third parties, such litigation will be costly and time consuming, and an unfavorable outcome would have a significant adverse effect on our business.***

Our ability to commercialize drugs depends on our ability to sell such drugs without infringing the patents or other proprietary rights of third parties. Numerous U.S. and foreign issued patents and pending patent applications owned by third parties exist in the areas that we are exploring. In addition, because patent applications can take several years to issue, there may be currently pending applications, unknown to us, which may later result in issued patents that our drug candidates may infringe. There could also be existing patents of which we are not aware that our drug candidates may inadvertently infringe.

In particular, we are aware of an issued U.S. patent and at least one pending U.S. patent application assigned to Curis, Inc., or Curis, relating to certain compounds in the quinazolinone class. Ispinesib falls into this class of compounds. The Curis patent claims a method of use for inhibiting signaling by what is called the hedgehog pathway using certain such compounds. Curis has pending applications in Europe, Japan, Australia and Canada with claims covering certain quinazolinone compounds, compositions thereof and/or methods of their use. We are also aware that two of the Australian applications have been allowed and two of the European applications have been granted. In Europe, Australia and elsewhere, the grant of a patent may be opposed by one or more parties. We and GSK have each opposed the granting of certain such patents to Curis in Europe and in Australia. A third party has also opposed the grant of one of Curis' European patents. Curis or a third party may assert that the sale of ispinesib may infringe one or more of these or other patents. We believe that we have valid defenses against the Curis patents if asserted against us. However, we cannot guarantee that a court would find such defenses valid or that such oppositions would be successful. We have not attempted to obtain a license to this patent. If we decide to obtain a license to these patents, we cannot guarantee that we would be able to obtain such a license on commercially reasonable terms, or at all.

In addition, we are aware of various issued U.S. and foreign patents and pending U.S. and foreign patent applications assigned to Cellomics, Inc., or Cellomics, relating to an automated method for analyzing cells. We received a letter from Cellomics notifying us that it believes we may be practicing one or more of the Cellomics patents and offering a use license for such patents through its licensing program. Cellomics has since become a wholly owned subsidiary of Fisher Scientific International, Inc., or Fisher. In May 2006, Fisher agreed to merge with Thermo Electron Corporation to form a new entity to be called Thermo Fisher Scientific Inc., or Thermo Fisher. Cellomics, Fisher, Thermo Fisher or a third party may assert that our Cytometrix<sup>®</sup> technologies for cell analysis fall within the scope of, and thus infringe, one or more of these patents. We believe that we have persuasive defenses to such an assertion. However, we cannot guarantee that a court would find such defenses persuasive. If we decide to obtain a license to these patents, we cannot guarantee that we would be able to obtain such a license on commercially reasonable terms, or at all.

Other future products of ours may be impacted by patents of companies engaged in competitive programs with significantly greater resources (such as Merck & Co., Inc., or Merck, Eli Lilly and Company, or Lilly, Bristol-Myers Squibb, or BMS, and Array Biopharma Inc., or Array). Further development of these products could be impacted by these patents and result in the expenditure of significant legal fees.

If a third party claims that our actions infringe on their patents or other proprietary rights, we could face a number of issues that could seriously harm our competitive position, including, but not limited to:

infringement and other intellectual property claims that, with or without merit, can be costly and time consuming to litigate and can delay the regulatory approval process and divert management's attention from our core business strategy;

substantial damages for past infringement which we may have to pay if a court determines that our drugs or technologies infringe a competitor's patent or other proprietary rights;

a court prohibiting us from selling or licensing our drugs or technologies unless the holder licenses the patent or other proprietary rights to us, which it is not required to do; and

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if a license is available from a holder, we may have to pay substantial royalties or grant cross licenses to our patents or other proprietary rights.

***We may become involved in disputes with our strategic partners over intellectual property ownership, and publications by our research collaborators and scientific advisors could impair our ability to obtain patent protection or protect our proprietary information, which, in either case, would have a significant impact on our business.***

Inventions discovered under our strategic alliance agreements become jointly owned by our strategic partners and us in some cases, and the exclusive property of one of us in other cases. Under some circumstances, it may be difficult to determine who owns a particular invention, or whether it is jointly owned, and disputes could arise regarding ownership of those inventions. These disputes could be costly and time consuming, and an unfavorable outcome would have a significant adverse effect on our business if we were not able to protect or license rights to these inventions. In addition, our research collaborators and scientific advisors have contractual rights to publish our data and other proprietary information, subject to our prior review. Publications by our research collaborators and scientific advisors containing such information, either with our permission or in contravention of the terms of their agreements with us, may impair our ability to obtain patent protection or protect our proprietary information, which could significantly harm our business.

***To the extent we elect to fund the development of a drug candidate or the commercialization of a drug at our expense, we will need substantial additional funding.***

The discovery, development and commercialization of novel small molecule drugs focused on the cytoskeleton for the treatment of a wide array of diseases is costly. As a result, to the extent we elect to fund the development of a drug candidate or the commercialization of a drug at our expense, we will need to raise additional capital to:

expand our research and development and technologies;

fund clinical trials and seek regulatory approvals;

build or access manufacturing and commercialization capabilities;

implement additional internal systems and infrastructure;

maintain, defend and expand the scope of our intellectual property; and

hire and support additional management and scientific personnel.

Our future funding requirements will depend on many factors, including, but not limited to:

the rate of progress and cost of our clinical trials and other research and development activities;

the costs and timing of seeking and obtaining regulatory approvals;

the costs associated with establishing manufacturing and commercialization capabilities;

the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights;

the costs of acquiring or investing in businesses, products and technologies;

the effect of competing technological and market developments; and

the payment and other terms and timing of any strategic alliance, licensing or other arrangements that we may establish.

Until we can generate a sufficient amount of product revenue to finance our cash requirements, which we may never do, we expect to continue to finance our future cash needs primarily through public or private equity offerings, debt financings and strategic alliances. We cannot be certain that additional funding will be available on acceptable terms, or at all. If we are not able to secure

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additional funding when needed, we may have to delay, reduce the scope of or eliminate one or more of our clinical trials or research and development programs or future commercialization initiatives.

***We have limited capacity to carry out our own clinical trials in connection with the development of our drug candidates and potential drug candidates, and to the extent we elect to develop a drug candidate without a strategic partner we will need to expand our development capacity, and will require additional funding.***

The development of drug candidates is complicated, and the required resources and experience that we currently have to carry out such development are limited. Currently, we generally rely on GSK and the NCI to carry out these activities for certain of our drug candidates. We do not have a partner for our cardiac myosin activator drug candidate, CK-1827452, and, if GSK elects to terminate its development efforts, we do not have an alternative partner for our current and potential cancer drug candidates. Pursuant to our Collaboration and License Agreement with GSK, we may initiate and conduct clinical trials for our drug candidate SB-743921 for the treatment of non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma. For the clinical trials we conduct with SB-743921 for these hematologic cancer indications, we plan to rely on contractors for the manufacture and distribution of clinical supplies. To the extent we conduct clinical trials for a drug candidate without support from a strategic partner, as we are doing with CK-1827452 and SB-743921, we will need to develop additional skills, technical expertise and resources necessary to carry out such development efforts on our own or through the use of other third parties, such as contract research organizations, or CROs.

If we utilize CROs, we will not have control over many aspects of their activities, and will not be able to fully control the amount or timing of resources that they devote to our programs. These third parties also may not assign as high a priority to our programs or pursue them as diligently as we would if we were undertaking such programs ourselves, and therefore may not complete their respective activities on schedule. CROs may also have relationships with our competitors and potential competitors, and may prioritize those relationships ahead of their relationships with us. Typically, we would prefer to qualify more than one vendor for each function performed outside of our control, which could be time consuming and costly. The failure of CROs to carry out development efforts on our behalf according to our requirements and FDA or other regulatory agencies' standards and in accordance with applicable laws, or our failure to properly coordinate and manage such efforts, could increase the cost of our operations and delay or prevent the development, approval and commercialization of our drug candidates. In addition, if a CRO fails to perform as agreed, our ability to collect damages may be contractually limited.

If we fail to develop the additional skills, technical expertise and resources necessary to carry out the development of our drug candidates, or if we fail to effectively manage our CROs carrying out such development, the commercialization of our drug candidates will be delayed or prevented.

***We have no manufacturing capacity and depend on our strategic partners or contract manufacturers to produce our clinical trial drug supplies for each of our drug candidates and potential drug candidates, and anticipate continued reliance on contract manufacturers for the development and commercialization of our potential drugs.***

We do not currently operate manufacturing facilities for clinical or commercial production of our drug candidates or potential drug candidates. We have limited experience in drug formulation and manufacturing, and we lack the resources and the capabilities to manufacture any of our drug candidates on a clinical or commercial scale. As a result, we currently rely on GSK to manufacture, supply, store and distribute drug supplies for its ispinesib and SB-743921 clinical trials, and will rely on GSK to be responsible for such activities for the planned GSK-923295 clinical trial. For our drug candidate CK-1827452, and our drug candidate SB-743921 for non-Hodgkin's lymphoma, Hodgkin's lymphoma and multiple myeloma, we currently rely on a limited number of contract manufacturers, and, in particular, we expect to rely on single-source contract manufacturers for the active pharmaceutical ingredient and the drug product supply for our clinical trials. In addition, we anticipate continued reliance on a limited number of contract manufacturers. Any performance failure on the part of our existing or future contract manufacturers could delay clinical development or regulatory approval of our drug candidates or commercialization of our drugs, producing additional losses and depriving us of potential product revenues. In addition, if a contract manufacturer fails to perform as agreed, our ability to collect damages may be contractually limited.

Our drug candidates require precise, high quality manufacturing. Our, our strategic partners' or any contract manufacturer's failure to achieve and maintain high manufacturing standards, including the incidence of manufacturing



errors, could result in patient injury or death, product recalls or withdrawals, delays or failures in product testing or delivery, cost overruns or other problems that could seriously hurt our business. Contract drug manufacturers often encounter difficulties involving production yields, quality control and quality assurance, as well as shortages of qualified personnel. These manufacturers are subject to stringent regulatory requirements, including the FDA's current good manufacturing practices regulations and similar foreign laws, as well as ongoing periodic unannounced inspections by the FDA, the U.S. Drug Enforcement Agency and other regulatory agencies, to ensure strict compliance

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with current good manufacturing practices and other applicable government regulations and corresponding foreign standards. However, we do not have control over our contract manufacturers' compliance with these regulations and standards. If one of our contract manufacturers fails to maintain compliance, the production of our drug candidates could be interrupted, resulting in delays, additional costs and potentially lost revenues. Additionally, our contract manufacturer must pass a preapproval inspection before we can obtain marketing approval for any of our drug candidates in development.

If the FDA or other regulatory agencies approve any of our drug candidates for commercial sale, we will need to manufacture them in larger quantities. To date, our drug candidates have been manufactured only in small quantities for preclinical testing and clinical trials. We may not be able to successfully increase the manufacturing capacity, whether in collaboration with contract manufacturers or on our own, for any of our drug candidates in a timely or economic manner, or at all. Significant scale-up of manufacturing may require additional validation studies, which the FDA must review and approve. If we are unable to successfully increase the manufacturing capacity for a drug candidate, the regulatory approval or commercial launch of any related drugs may be delayed or there may be a shortage in supply. Even if any contract manufacturer makes improvements in the manufacturing process for our drug candidates, we may not own, or may have to share, the intellectual property rights to such improvements.

In addition, our existing and future contract manufacturers may not perform as agreed or may not remain in the contract manufacturing business for the time required to successfully produce, store and distribute our drug candidates. If a natural disaster, business failure, strike or other difficulty occurs, we may be unable to replace such contract manufacturer in a timely manner and the production of our drug candidates would be interrupted, resulting in delays and additional costs.

Switching manufacturers or manufacturing sites may be difficult and time consuming because the number of potential manufacturers is limited. In addition, prior to the commercialization of a drug from any replacement manufacturer or manufacturing site, the FDA must approve that site. Such approval would require new testing and compliance inspections. In addition, a new manufacturer or manufacturing site would have to be educated in, or develop substantially equivalent processes for, production of our drugs after receipt of FDA approval. It may be difficult or impossible for us to find a replacement manufacturer on acceptable terms quickly, or at all.

***We currently have no marketing or sales staff, and if we are unable to enter into or maintain strategic alliances with marketing partners or if we are unable to develop our own sales and marketing capabilities, we may not be successful in commercializing our potential drugs.***

We currently have no sales, marketing or distribution capabilities. To commercialize our drugs that we determine not to market on our own, we will depend on strategic alliances with third parties, such as GSK, which have established distribution systems and direct sales forces. If we are unable to enter into such arrangements on acceptable terms, we may not be able to successfully commercialize such drugs.

We plan to commercialize drugs on our own, with or without a partner, that can be effectively marketed and sold in concentrated markets that do not require a large sales force to be competitive. To achieve this goal, we will need to establish our own specialized sales force and marketing organization with technical expertise and with supporting distribution capabilities. Developing such an organization is expensive and time consuming and could delay a product launch. In addition, we may not be able to develop this capacity efficiently, or at all, which could make us unable to commercialize our drugs.

To the extent that we are not successful in commercializing any drugs ourselves or through a strategic alliance, our product revenues will suffer, we will incur significant additional losses and the price of our common stock will be negatively affected.

***We expect to expand our development, clinical research, sales and marketing capabilities, and as a result, we may encounter difficulties in managing our growth, which could disrupt our operations.***

We expect to have significant growth in expenditures, the number of our employees and the scope of our operations, in particular with respect to those drug candidates that we elect to develop or commercialize independently or together with a partner. To manage our anticipated future growth, we must continue to implement and improve our managerial, operational and financial systems, expand our facilities and continue to recruit and train additional qualified personnel. Due to our limited resources, we may not be able to effectively manage the expansion of our

operations or recruit and train additional qualified personnel. The physical expansion of our operations may lead to significant costs and may divert our management and business development resources. Any inability to manage growth could delay the execution of our business plans or disrupt our operations.

**Table of Contents*****The failure to attract and retain skilled personnel could impair our drug development and commercialization efforts.***

Our performance is substantially dependent on the performance of our senior management and key scientific and technical personnel, particularly James H. Sabry, M.D., Ph.D., our Chief Executive Officer, Robert I. Blum, our President, Andrew A. Wolff, M.D., F.A.C.C., our Senior Vice President, Clinical Research and Chief Medical Officer, Sharon A. Surrey-Barbari, our Senior Vice President, Finance and Chief Financial Officer, David J. Morgans, Ph.D., our Senior Vice President of Preclinical Research and Development, Jay K. Trautman, Ph.D., our Vice President of Research, and David Cragg, our Vice President of Human Resources. The employment of these individuals and our other personnel is terminable at will with short or no notice. We carry key person life insurance on James H. Sabry. The loss of the services of any member of our senior management, scientific or technical staff may significantly delay or prevent the achievement of drug development and other business objectives by diverting management's attention to transition matters and identification of suitable replacements, and could have a material adverse effect on our business, operating results and financial condition. We also rely on consultants and advisors to assist us in formulating our research and development strategy. All of our consultants and advisors are either self-employed or employed by other organizations, and they may have conflicts of interest or other commitments, such as consulting or advisory contracts with other organizations, that may affect their ability to contribute to us.

In addition, we believe that we will need to recruit additional executive management and scientific and technical personnel. There is currently intense competition for skilled executives and employees with relevant scientific and technical expertise, and this competition is likely to continue. Our inability to attract and retain sufficient scientific, technical and managerial personnel could limit or delay our product development efforts, which would adversely affect the development of our drug candidates and commercialization of our potential drugs and growth of our business.

**Risks Related to Our Industry*****Our competitors may develop drugs that are less expensive, safer, or more effective, which may diminish or eliminate the commercial success of any drugs that we may commercialize.***

We compete with companies that are also developing drug candidates that focus on the cytoskeleton, as well as companies that have developed drugs or are developing alternative drug candidates for cancer and cardiovascular and other diseases for which our compounds may be useful treatments. For example, if approved for marketing by the FDA, depending on the approved clinical indication, our cancer drug candidates such as ispinesib and SB-743921 could compete against existing cancer treatments such as paclitaxel, docetaxel, vincristine, vinorelbine or navelbine and potentially against other novel cancer drug candidates that are currently in development such as those that are reformulated taxanes, other tubulin binding compounds or epothilones. We are also aware that Merck, Lilly, Array, BMS and others are conducting research and development focused on KSP and other mitotic kinesins. In addition, BMS, Merck, Novartis, Genentech, Inc. and other pharmaceutical and biopharmaceutical companies are developing other approaches to inhibiting mitosis.

With respect to heart failure, if CK-1827452 or any other of our compounds is approved for marketing by the FDA for heart failure, that compound could compete against current generically available therapies, such as milrinone, dobutamine or digoxin or newer drugs such as nesiritide, as well as potentially against other novel drug candidates in development such as ularitide, which is being developed by PDL Biopharma, Inc., urocortin II, which is being developed by Neurocrine Biosciences, Inc., and levosimendan, which is being developed in the United States by Abbott Laboratories and is commercially available in a number of countries outside of the United States.

Our competitors may:

develop drug candidates and market drugs that are less expensive or more effective than our future drugs;

commercialize competing drugs before we or our partners can launch any drugs developed from our drug candidates;

hold or obtain proprietary rights that could prevent us from commercializing our products;

initiate or withstand substantial price competition more successfully than we can;

have greater success in recruiting skilled scientific workers from the limited pool of available talent;

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more effectively negotiate third-party licenses and strategic alliances;

take advantage of acquisition or other opportunities more readily than we can;

develop drug candidates and market drugs that increase the levels of safety or efficacy or alter other drug candidate profile aspects that our drug candidates will need to show in order to obtain regulatory approval;  
or

introduce therapies or market drugs that render the market opportunity for our potential drugs obsolete.

We will compete for market share against large pharmaceutical and biotechnology companies and smaller companies that are collaborating with larger pharmaceutical companies, new companies, academic institutions, government agencies and other public and private research organizations. Many of these competitors, either alone or together with their partners, may develop new drug candidates that will compete with ours. These competitors may, and in certain cases do, operate larger research and development programs or have substantially greater financial resources than we do. Our competitors may also have significantly greater experience in:

developing drug candidates;

undertaking preclinical testing and clinical trials;

building relationships with key customers and opinion-leading physicians;

obtaining and maintaining FDA and other regulatory approvals of drug candidates;

formulating and manufacturing drugs; and

launching, marketing and selling drugs.

If our competitors market drugs that are less expensive, safer or more efficacious than our potential drugs, or that reach the market sooner than our potential drugs, we may not achieve commercial success. In addition, the life sciences industry is characterized by rapid technological change. Because our research approach integrates many technologies, it may be difficult for us to stay abreast of the rapid changes in each technology. If we fail to stay at the forefront of technological change we may be unable to compete effectively. Our competitors may render our technologies obsolete by advances in existing technological approaches or the development of new or different approaches, potentially eliminating the advantages in our drug discovery process that we believe we derive from our research approach and proprietary technologies.

***The regulatory approval process is expensive, time consuming and uncertain and may prevent our partners or us from obtaining approvals to commercialize some or all of our drug candidates.***

The research, testing, manufacturing, selling and marketing of drug candidates are subject to extensive regulation by the FDA and other regulatory authorities in the United States and other countries, which regulations differ from country to country. Neither we nor our partners are permitted to market our potential drugs in the United States until we receive approval of a New Drug Application, or NDA, from the FDA. Neither we nor our partners have received marketing approval for any of Cytokinetics' drug candidates. Obtaining approval of an NDA can be a lengthy, expensive and uncertain process. In addition, failure to comply with the FDA and other applicable foreign and U.S. regulatory requirements may subject us to administrative or judicially imposed sanctions. These include warning letters, civil and criminal penalties, injunctions, product seizure or detention, product recalls, total or partial suspension of production, and refusal to approve pending NDAs or supplements to approved NDAs.

Regulatory approval of an NDA or NDA supplement is never guaranteed, and the approval process typically takes several years and is extremely expensive. The FDA also has substantial discretion in the drug approval process. Despite the time and expense exerted, failure can occur at any stage, and we could encounter problems that cause us to abandon clinical trials or to repeat or perform additional preclinical testing and clinical trials. The number and focus of

preclinical studies and clinical trials that will be required for FDA approval varies depending on the drug candidate, the disease or condition that the drug candidate is designed to address, and the regulations applicable to any particular drug candidate. The FDA can delay, limit or deny approval of a drug candidate for many reasons, including, but not limited to:

a drug candidate may not be safe or effective;

the FDA may not find the data from preclinical testing and clinical trials sufficient;

the FDA might not approve our or our contract manufacturer's processes or facilities; or

the FDA may change its approval policies or adopt new regulations.

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***If we or our partners receive regulatory approval for our drug candidates, we will also be subject to ongoing FDA obligations and continued regulatory review, such as continued safety reporting requirements, and we may also be subject to additional FDA post-marketing obligations, all of which may result in significant expense and limit our ability to commercialize our potential drugs.***

Any regulatory approvals that we or our partners receive for our drug candidates may be subject to limitations on the indicated uses for which the drug may be marketed or contain requirements for potentially costly post-marketing follow-up studies. In addition, if the FDA approves any of our drug candidates, the labeling, packaging, adverse event reporting, storage, advertising, promotion and record-keeping for the drug will be subject to extensive regulatory requirements. The subsequent discovery of previously unknown problems with the drug, including adverse events of unanticipated severity or frequency, or the discovery that adverse effects or toxicities previously observed in preclinical research or clinical trials that were believed to be minor actually constitute much more serious problems, may result in restrictions on the marketing of the drug, and could include withdrawal of the drug from the market.

The FDA's policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our drug candidates. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the United States or abroad. If we are not able to maintain regulatory compliance, we might not be permitted to market our drugs and our business could suffer.

***If physicians and patients do not accept our drugs, we may be unable to generate significant revenue, if any.***

Even if our drug candidates obtain regulatory approval, resulting drugs, if any, may not gain market acceptance among physicians, healthcare payors, patients and the medical community. Even if the clinical safety and efficacy of drugs developed from our drug candidates are established for purposes of approval, physicians may elect not to recommend these drugs for a variety of reasons including, but not limited to:

timing of market introduction of competitive drugs;

clinical safety and efficacy of alternative drugs or treatments;

cost-effectiveness;

availability of coverage and reimbursement from health maintenance organizations and other third-party payors;

convenience and ease of administration;

prevalence and severity of adverse side effects;

other potential disadvantages relative to alternative treatment methods; or

insufficient marketing and distribution support.

If our drugs fail to achieve market acceptance, we may not be able to generate significant revenue and our business would suffer.

***The coverage and reimbursement status of newly approved drugs is uncertain and failure to obtain adequate coverage and reimbursement could limit our ability to market any drugs we may develop and decrease our ability to generate revenue.***

There is significant uncertainty related to the coverage and reimbursement of newly approved drugs. The commercial success of our potential drugs in both domestic and international markets is substantially dependent on whether third-party coverage and reimbursement is available for the ordering of our potential drugs by the medical profession for use by their patients. Medicare, Medicaid, health maintenance organizations and other third-party payors are increasingly attempting to contain healthcare costs by limiting both coverage and the level of reimbursement of new drugs, and, as a result, they may not cover or provide adequate payment for our potential drugs. They may not view our potential drugs as cost-effective and reimbursement may not be available to consumers or may



not be sufficient to allow our potential drugs to be marketed on a competitive basis. If we are unable to obtain adequate coverage and reimbursement for our potential drugs, our ability to generate revenue may be adversely affected. Likewise, legislative or regulatory efforts to control or reduce healthcare costs or reform government healthcare programs could result in lower prices or rejection of coverage and reimbursement for our potential drugs. Changes in coverage and reimbursement policies or healthcare cost containment initiatives that limit or restrict reimbursement for our drugs may cause our revenue to decline.

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***We may be subject to costly product liability claims and may not be able to obtain adequate insurance.***

If we conduct clinical trials in humans, we face the risk that the use of our drug candidates will result in adverse effects. We currently maintain product liability insurance. We cannot predict the possible harms or side effects that may result from our clinical trials. We may not have sufficient resources to pay for any liabilities resulting from a claim excluded from, or beyond the limit of, our insurance coverage.

In addition, once we have commercially launched drugs based on our drug candidates, we will face exposure to product liability claims. This risk exists even with respect to those drugs that are approved for commercial sale by the FDA and manufactured in facilities licensed and regulated by the FDA. We intend to secure limited product liability insurance coverage, but may not be able to obtain such insurance on acceptable terms with adequate coverage, or at reasonable costs. There is also a risk that third parties that we have agreed to indemnify could incur liability, or that third parties that have agreed to indemnify us do not fulfill their obligations. Even if we were ultimately successful in product liability litigation, the litigation would consume substantial amounts of our financial and managerial resources and may create adverse publicity, all of which would impair our ability to generate sales of the affected product as well as our other potential drugs. Moreover, product recalls may be issued at our discretion or at the direction of the FDA, other governmental agencies or other companies having regulatory control for drug sales. If product recalls occur, they are generally expensive and often have an adverse effect on the image of the drugs being recalled as well as the reputation of the drug's developer or manufacturer.

***We may be subject to damages resulting from claims that we or our employees have wrongfully used or disclosed alleged trade secrets of their former employers.***

Many of our employees were previously employed at universities or other biotechnology or pharmaceutical companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that these employees or we have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. If we fail in defending such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hamper or prevent our ability to commercialize certain potential drugs, which could severely harm our business. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management.

***We use hazardous chemicals and radioactive and biological materials in our business. Any claims relating to improper handling, storage or disposal of these materials could be time consuming and costly.***

Our research and development processes involve the controlled use of hazardous materials, including chemicals and radioactive and biological materials. Our operations produce hazardous waste products. We cannot eliminate the risk of accidental contamination or discharge and any resultant injury from those materials. Federal, state and local laws and regulations govern the use, manufacture, storage, handling and disposal of hazardous materials. We may be sued for any injury or contamination that results from our use or the use by third parties of these materials. Compliance with environmental laws and regulations is expensive, and current or future environmental regulations may impair our research, development and production efforts.

In addition, our partners may use hazardous materials in connection with our strategic alliances. To our knowledge, their work is performed in accordance with applicable biosafety regulations. In the event of a lawsuit or investigation, however, we could be held responsible for any injury caused to persons or property by exposure to, or release of, these hazardous materials used by these parties. Further, we may be required to indemnify our partners against all damages and other liabilities arising out of our development activities or drugs produced in connection with these strategic alliances.

***Our facilities in California are located near an earthquake fault, and an earthquake or other types of natural disasters or resource shortages could disrupt our operations and adversely affect results.***

Important documents and records, such as hard copies of our laboratory books and records for our drug candidates and compounds, are located in our corporate headquarters at a single location in South San Francisco, California near active earthquake zones. In the event of a natural disaster, such as an earthquake or flood, or localized extended outages of critical utilities or transportation systems, we do not have a formal business continuity or disaster recovery plan, and could therefore experience a significant business interruption. In addition, California from time to time has

experienced shortages of water, electric power and natural gas. Future shortages and conservation measures could disrupt our operations and cause expense, thus adversely affecting our business and financial results.

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**Risks Related To Our Common Stock**

*We expect that our stock price will fluctuate significantly, and you may not be able to resell your shares at or above your investment price.*

The stock market, particularly in recent years, has experienced significant volatility, particularly with respect to pharmaceutical, biotechnology and other life sciences company stocks. The volatility of pharmaceutical, biotechnology and other life sciences company stocks often does not relate to the operating performance of the companies represented by the stock. Factors that could cause volatility in the market price of our common stock include, but are not limited to:

- results from, delays in, or discontinuation of, any of the clinical trials for our drug candidates for the treatment of cancer or heart failure, including the current and proposed clinical trials for ispinesib, SB-743921 and GSK-923295 for cancer, and CK-1827452 for heart failure, and including delays resulting from slower than expected or suspended patient enrollment or discontinuations resulting from a failure to meet pre-defined clinical end-points;
- delays in or discontinuation of the development of any of our drug candidates by GSK;
- failure or delays in entering additional drug candidates into clinical trials;
- failure or discontinuation of any of our research programs;
- delays or other developments in establishing new strategic alliances;
- announcements concerning our strategic alliances with GSK or AstraZeneca or future strategic alliances;
- announcements concerning clinical trials being initiated or conducted by the NCI;
- issuance of new or changed securities analysts' reports or recommendations;
- market conditions in the pharmaceutical, biotechnology and other healthcare related sectors;
- actual or anticipated fluctuations in our quarterly financial and operating results;
- developments or disputes concerning our intellectual property or other proprietary rights;
- introduction of technological innovations or new commercial products by us or our competitors;
- issues in manufacturing our drug candidates or drugs;
- market acceptance of our drugs;
- third-party healthcare coverage and reimbursement policies;
- FDA or other U.S. or foreign regulatory actions affecting us or our industry;
- litigation or public concern about the safety of our drug candidates or drugs;
- additions or departures of key personnel; or
- volatility in the stock prices of other companies in our industry.

These and other external factors may cause the market price and demand for our common stock to fluctuate substantially, which may limit or prevent investors from readily selling their shares of common stock and may otherwise negatively affect the liquidity of our common stock. In addition, when the market price of a stock has been volatile, holders of that stock have instituted securities class action litigation against the company that issued the stock. If any of our stockholders brought a lawsuit against us, we could incur substantial costs defending the lawsuit. Such a lawsuit could also divert our management's time and attention.

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***If the ownership of our common stock continues to be highly concentrated, it may prevent you and other stockholders from influencing significant corporate decisions and may result in conflicts of interest that could cause our stock price to decline.***

As of July 31, 2006, our executive officers, directors and their affiliates beneficially owned or controlled approximately 31.6% percent of the outstanding shares of our common stock (after giving effect to the exercise of all outstanding vested and unvested options and warrants). Accordingly, these executive officers, directors and their affiliates, acting as a group, will have substantial influence over the outcome of corporate actions requiring stockholder approval, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets or any other significant corporate transactions. These stockholders may also delay or prevent a change of control of us, even if such a change of control would benefit our other stockholders. The significant concentration of stock ownership may adversely affect the trading price of our common stock due to investors' perception that conflicts of interest may exist or arise.

***Evolving regulation of corporate governance and public disclosure may result in additional expenses and continuing uncertainty.***

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and Nasdaq National Market rules are creating uncertainty for public companies. We are presently evaluating and monitoring developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs. For example, compliance with the internal control requirements of Sarbanes-Oxley Section 404 has to date required the commitment of significant resources to document and test the adequacy of our internal control over financial reporting. While our assessment, testing and evaluation of the design and operating effectiveness of our internal control over financial reporting resulted in our conclusion that as of December 31, 2005 our internal control over financial reporting was effective, we can provide no assurance as to conclusions of management or by our independent registered public accounting firm with respect to the effectiveness of our internal control over financial reporting in the future. These new or changed laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest the resources necessary to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies, due to ambiguities related to practice or otherwise, regulatory authorities may initiate legal proceedings against us and our reputation and business may be harmed.

***Volatility in the stock prices of other companies may contribute to volatility in our stock price.***

The stock market in general, and Nasdaq 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 particular volatility in the market prices of securities of early stage and development stage life sciences 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.

***We have never paid dividends on our capital stock, and we do not anticipate paying any cash dividends in the foreseeable future.***

We have paid no cash dividends on any of our classes of capital stock to date and we currently intend to retain our future earnings, if any, to fund the development and growth of our businesses. In addition, the terms of existing or any future debts may preclude us from paying these dividends.

***Our common stock is thinly traded and there may not be an active, liquid trading market for our common stock.***

There is no guarantee that an active trading market for our common stock will be maintained on Nasdaq, or that the volume of trading will be sufficient to allow for timely trades. Investors may not be able to sell their shares quickly or at the latest market price if trading in our stock is not active or if trading volume is limited. In addition, if trading volume in our common stock is limited, trades of relatively small numbers of shares may have a disproportionate effect on the market price of our common stock.

**Table of Contents****Risks Related To The Committed Equity Financing Facility With Kingsbridge**

*Our committed equity financing facility with Kingsbridge may not be available to us if we elect to make a draw down, may require us to make additional blackout or other payments to Kingsbridge, and may result in dilution to our stockholders.*

In October 2005, we entered into the CEFF with Kingsbridge. The CEFF entitles us to sell and obligates Kingsbridge to purchase, from time to time over a period of three years, shares of our common stock for cash consideration up to an aggregate of \$75.0 million, subject to certain conditions and restrictions. Kingsbridge will not be obligated to purchase shares under the CEFF unless certain conditions are met, which include a minimum price for our common stock; the accuracy of representations and warranties made to Kingsbridge; compliance with laws; effectiveness of a registration statement registering for resale the shares of common stock to be issued in connection with the CEFF and the continued listing of our stock on the Nasdaq National Stock market. In addition, Kingsbridge is permitted to terminate the CEFF if it determines that a material and adverse event has occurred affecting our business, operations, properties or financial condition and if such condition continues for a period of 10 days from the date Kingsbridge provides us notice of such material and adverse event. If we are unable to access funds through the CEFF, or if the CEFF is terminated by Kingsbridge, we may be unable to access capital on favorable terms or at all.

We are entitled, in certain circumstances, to deliver a blackout notice to Kingsbridge to suspend the use of the resale registration statement and prohibit Kingsbridge from selling shares under the resale registration statement. If we deliver a blackout notice in the 15 trading days following the settlement of a draw down, or if the resale registration statement is not effective in circumstances not permitted by the agreement, then we must make a payment to Kingsbridge, or issue Kingsbridge additional shares in lieu of this payment, calculated on the basis of the number of shares held by Kingsbridge (exclusive of shares that Kingsbridge may hold pursuant to exercise of the Kingsbridge warrant) and the change in the market price of our common stock during the period in which the use of the registration statement is suspended. If the trading price of our common stock declines during a suspension of the resale registration statement, the blackout or other payment could be significant.

Should we sell shares to Kingsbridge under the CEFF, or issue shares in lieu of a blackout payment, it will have a dilutive effective on the holdings of our current stockholders, and may result in downward pressure on the price of our common stock. If we draw down under the CEFF, we will issue shares to Kingsbridge at a discount of up to 10 percent from the volume weighted average price of our common stock. If we draw down amounts under the CEFF when our share price is decreasing, we will need to issue more shares to raise the same amount than if our stock price was higher. Issuances in the face of a declining share price will have an even greater dilutive effect than if our share price were stable or increasing, and may further decrease our share price.

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

(c) The following table summarizes employee stock repurchase activity for the three months ended June 30, 2006:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
April 1 to April 30, 2006				
May 1 to May 31, 2006	574	\$ 1.20		



June 1 to June 30, 2006

Total	574	\$ 1.20
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The total number of shares repurchased represents shares of our common stock that we repurchased from employees upon termination of employment. As June 30, 2006, approximately 14,148 shares of common stock held by employees and service providers remain subject to repurchase by us.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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**Table of Contents****ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our Annual Meeting of Stockholders was held on May 25, 2006 in South San Francisco, California. Of the 35,595,682 shares of the Company's common stock entitled to vote at the meeting, 26,570,457 shares of common stock, or 76%, of the total eligible votes to be cast, were represented at the meeting in person or by proxy, constituting a quorum. The voting results were as follows:

The stockholders elected James A. Spudich and Charles Homcy as Class II directors, each to serve for a three-year term until their successors are duly elected and qualified. The votes were as follows:

<b>Name</b>	<b>For</b>	<b>Withheld</b>
James A. Spudich	23,171,757	3,398,700
Charles Homcy	20,522,820	6,047,637

The stockholders ratified the selection by the Audit Committee of the Board of Directors of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2006. The votes were as follows:

<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Vote</b>
26,550,897	15,510	4,050	

The stockholders approved the Amendment to the Company's 2004 Employee Stock Purchase Plan to increase the number of shares of our common stock reserved for issuance under such plan by 1,000,000 to a new total of 1,500,000. The votes were as follows:

<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Vote</b>
21,446,001	2,141,303	7,850	2,975,303

**ITEM 5. OTHER INFORMATION**

On July 19, 2006 the Compensation Committee of the Board of Directors recommended, and the Board of Directors approved, a change in the compensation paid to non-employee directors. The following is a summary of the non-employee director compensation arrangements:

	<b>Dollars (\$)</b>
<b>Cash-based Compensation:</b>	
<i>Annual Retainer Fee:</i>	
All non-employee directors	20,000
Chairman of the Audit Committee	10,000
Chairman of the Compensation Committee	5,000
Chairman of the Nominating and Governance Committee	5,000
Other standing members of Board Committees (1)	2,500
<i>Board and Committee Meeting Attendance Fees:</i>	
Board meeting - personal attendance	1,500
Board meeting - telephonic attendance	1,000
Committee meeting (1) - personal attendance	1,000
Committee meeting (1) - telephonic attendance	650
	<b>Shares (#)</b>
<b>Equity-based Compensation:</b>	
Annual common stock option grant to all non-employee directors (2)	10,000
Initial common stock option grant to newly elected non-employee directors (3)	20,000

On August 4, 2006 the Company entered into an agreement with Portola whereby Portola will sub-lease approximately 2,500 square feet of office space from the Company at a monthly rate of \$1.75 per square foot. The term of the agreement commences once consent has been received from the master tenant, Millenium Pharmaceuticals, Inc., and the master landlord, Britannia Pointe Grand Limited Partnership, and continues until October 31, 2006, with the option to extend on a month-to-month basis thereafter.

- (1) Includes only the standing committees of the Board of Directors, consisting of the Audit Committee, Compensation Committee and Nominating and Governance Committee.
- (2) Shares underlying option are vested in full upon the date of grant.
- (3) One-third of the shares subject to such option vest at the end of each year after the date of grant.

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ITEM 6. EXHIBITS

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Amended and Restated Certificate of Incorporation. (1)
3.2	Amended and Restated Bylaws. (1)
4.1	Specimen Common Stock Certificate. (1)
4.2	Fourth Amended and Restated Investors Rights Agreement, dated March 21, 2003, by and among the Registrant and certain stockholders of the Registrant. (1)
4.3	Loan and Security Agreement, dated September 25, 1998, by and between the Registrant and Comdisco. (1)
4.4	Amendment No. One to Loan and Security Agreement, dated February 1, 1999. (1)
4.5	Warrant for the purchase of shares of Series A preferred stock, dated September 25, 1998, issued by the Registrant to Comdisco. (1)
4.6	Loan and Security Agreement, dated December 16, 1999, by and between the Registrant and Comdisco. (1)
4.7	Amendment No. 1 to Loan and Security Agreement, dated June 29, 2000, by and between the Registrant and Comdisco. (1)
4.8	Warrant for the purchase of shares of Series B preferred stock, dated December 16, 1999, issued by the Registrant to Comdisco. (1)
4.9	Master Security Agreement, dated February 2, 2001, by and between the Registrant and General Electric Capital Corporation. (1)
4.10	Cross-Collateral and Cross-Default Agreement by and between the Registrant and Comdisco. (1)
4.11	Warrant for the purchase of shares of common stock, dated July 20, 1999, issued by the Registrant to Bristow Investments, L.P. (1)
4.12	Warrant for the purchase of shares of common stock, dated July 20, 1999, issued by the Registrant to the Laurence and Magdalena Shushan Family Trust. (1)
4.13	Warrant for the purchase of shares of common stock, dated July 20, 1999, issued by the Registrant to Slough Estates USA Inc. (1)
4.14	Warrant for the purchase of shares of Series B preferred stock, dated August 30, 1999, issued by the Registrant to The Magnum Trust. (1)
4.15	Warrant for the purchase of shares of common stock, dated October 28, 2005, issued by the Registrant and Kingsbridge Capital Limited. (2)
4.16	

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Registration Rights Agreement, dated October 28, 2005, by and between the Registrant and Kingsbridge Capital Limited. (2)

10.65\* Letter Amendment to the Collaboration Agreement, dated June 16, 2006, by and between the Company and Glaxo Group Limited, a GlaxoSmithKline company. (3)

10.66 Sublease Agreement, dated August 4, 2006, by and between the Company and Portola Pharmaceuticals, Inc.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

(1) Incorporated by reference from our registration statement on Form S-1, registration number 333-112261, declared effective by the Securities and Exchange Commission on April 29, 2004.

(2) Incorporated by reference from our Current Report on Form 8-K, filed with the Securities and Exchange Commission on January 20, 2006.

(3) Incorporated by reference from our Current Report on Form 8-K, filed with the Securities and Exchange Commission on June 19, 2006.

\* Pursuant to a request for confidential treatment, portions of this Exhibit have been redacted from the publicly filed document and have been furnished separately to the Securities and Exchange Commission as required by Rule 24b-2 under the Securities Exchange Act of 1934.

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**SIGNATURES**

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

Dated: August 8, 2006

CYTOKINETICS, INCORPORATED  
(Registrant)

/s/ James H. Sabry

James H. Sabry  
Chief Executive Officer and Director  
(Principal Executive Officer)

/s/ Sharon Surrey-Barbari

Sharon Surrey-Barbari  
Senior Vice President, Finance and Chief Financial Officer  
(Principal Financial Officer)

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