Vanda Pharmaceuticals Inc.
Form 10-Q
August 08, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File Number: 000-51863

VANDA PHARMACEUTICALS INC.
(Exact name of registrant as specified in its charter)

Delaware	**03-0491827**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*
9605 Medical Center Drive, Suite 300 Rockville, Maryland *(Address of Principal Executive Offices)*	**20850** *(Zip Code)*

(240) 599-4500
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. Please see definition of accelerated and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

As of August 3, 2007, there were 26,626,604 shares of the Registrant s Common Stock issued and outstanding.

Vanda Pharmaceuticals Inc.
(A Development Stage Enterprise)

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For the Three and Six Months Ended June 30, 2007

PART I FINANCIAL INFORMATION

Item 1. *Financial Statements (Unaudited)*

VANDA PHARMACEUTICALS INC.
(A Development Stage Enterprise)

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 47,630,957	$ 30,928,895
Marketable securities	72,031,191	941,981
Prepaid expenses, deposits and other current assets	3,305,553	1,949,466
Total current assets	122,967,701	33,820,342
Property and equipment, net	1,770,566	1,859,704
Deposits	150,000	150,000
Restricted cash	430,230	430,230
Total assets	$ 125,318,497	$ 36,260,276
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,600,433	$ 2,783,249
Accrued expenses	6,290,164	6,322,808
Deferred grant revenue	141,229	
Total current liabilities	9,031,826	9,106,057
Deferred rent	253,736	238,413
Deferred grant revenue		129,950
Other long-term liabilities		28,984
Total liabilities	9,285,562	9,503,404
Commitments and contingencies		
Stockholders equity		
Common stock, $0.001 par value, 150,000,000 shares authorized as of June 30, 2007 and December 31, 2006; and 26,610,092 and 22,128,534 shares issued and outstanding as of June 30, 2007 and December 31, 2006, respectively	26,610	22,129
Additional paid-in capital	247,232,208	126,578,588

Accumulated other comprehensive loss	(7,524)	(3,269)
Deficit accumulated during the development stage	(131,218,359)	(99,840,576)
Total stockholders equity	116,032,935	26,756,872
Total liabilities and stockholders equity	$ 125,318,497	$ 36,260,276

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

VANDA PHARMACEUTICALS INC.
(A Development Stage Enterprise)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended		Six Months Ended		Period from March 13, 2003 (Inception) to
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Revenues from services	$	$	$	$	$ 81,545
Operating expenses:					
Research and development	10,193,825	19,099,850	20,785,884	34,588,404	99,200,790
General and administrative	7,449,375	2,980,642	13,682,924	5,905,590	37,888,679
Total operating expenses	17,643,200	22,080,492	34,468,808	40,493,994	137,089,469
Loss from operations	(17,643,200)	(22,080,492)	(34,468,808)	(40,493,994)	(137,007,924)
Other income (expense):					
Interest income	1,659,781	709,033	3,093,435	1,002,893	5,885,005
Interest expense		(1,625)		(4,433)	(80,485)
Other income					602
Total other income	1,659,781	707,408	3,093,435	998,460	5,805,122
Loss before tax expense	(15,983,419)	(21,373,084)	(31,375,373)	(39,495,534)	(131,202,802)
Tax expense	1,604		2,410		15,557
Net loss	(15,985,023)	(21,373,084)	(31,377,783)	(39,495,534)	(131,218,359)
Beneficial conversion feature deemed dividend to preferred stockholders					(33,486,623)
Net loss attributable to common stockholders	$ (15,985,023)	$ (21,373,084)	$ (31,377,783)	$ (39,495,534)	$ (164,704,982)
Basic and diluted net loss per share applicable to common stockholders	$ (0.60)	$ (1.11)	$ (1.21)	$ (4.11)	
Shares used in calculation of basic and diluted net	26,567,160	19,183,660	25,978,437	9,616,347	

loss per share applicable
to common stockholders

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

VANDA PHARMACEUTICALS INC.
(A Development Stage Enterprise)

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited)

	Common Stock		Additional	Accumulated Other	Deficit Accumulated During the	Comprehensive	
	Shares	Par Value	Paid-In Capital	Comprehensive Loss	Development Stage	Loss	Total
alances at ecember 31, 2006	22,128,534	$ 22,129	$ 126,578,588	$ (3,269)	$ (99,840,576)		$ 26,756,872
llow-on offering of mmon stock, net of suance costs	4,370,000	4,370	111,250,480				111,254,850
mployee ock-based mpensation			9,144,579				9,144,579
xercise of stock tions	111,558	111	79,476				79,587
on-employee ock-based mpensation			179,085				179,085
omprehensive loss:							
et loss					(31,377,783)	$ (31,377,783)	
umulative anslation adjustment				(29,363)		(29,363)	
et unrealized gains marketable curities				25,108		25,108	
omprehensive loss						$ (31,382,038)	(31,382,038)
alances at June 30, 007	26,610,092	$ 26,610	$ 247,232,208	$ (7,524)	$ (131,218,359)		$ 116,032,935

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

VANDA PHARMACEUTICALS INC.
(A Development Stage Enterprise)

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended		Period from March 13, 2003 (Inception) to
	June 30, 2007	June 30, 2006	June 30, 2007
Cash flows from operating activities			
Net loss	$ (31,377,783)	$ (39,495,534)	$ (131,218,359)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	293,660	247,860	1,725,686
Employee and non-employee stock-based compensation	9,323,664	3,017,878	20,636,373
Loss on disposal of assets		29,528	29,528
Accretion of discount on investments	(859,296)	(188,447)	(1,280,370)
Changes in assets and liabilities:			
Prepaid expenses, deposits and other current assets	(1,354,085)	792,458	(3,450,722)
Accounts payable	(183,682)	2,723,025	2,597,550
Accrued expenses	(33,290)	9,135,082	6,286,533
Deferred grant revenue			129,898
Other liabilities	(13,661)	142,711	253,736
Net cash used in operating activities	(24,204,473)	(23,595,439)	(104,290,147)
Cash flows from investing activities			
Purchases of property and equipment	(202,683)	(871,225)	(3,404,732)
Purchases of marketable securities	(93,239,541)	(96,197,639)	(207,318,325)
Proceeds from sales of marketable securities		82,137,888	82,137,888
Maturities of marketable securities	23,025,000	10,670,000	54,445,000
Investment in restricted cash			(430,230)
Net cash used in investing activities	(70,417,224)	(4,260,976)	(74,570,399)
Cash flows from financing activities			
Proceeds from borrowings on note payable			515,147
Principal payments on obligations under capital lease		(704)	(94,456)
Principal payments on note payable		(92,888)	(515,147)
Proceeds from issuance of preferred stock, net of issuance costs			61,795,187
Proceeds from exercise of stock options and warrants	79,587	48,885	238,457
Proceeds from issuance of common stock, net of issuance costs	111,254,850	53,329,951	164,588,801

Net cash provided by financing activities	111,334,437	53,285,244	226,527,989
Effect of foreign currency translation	(10,678)	(2,023)	(36,486)
Net increase in cash and cash equivalents	16,702,062	25,426,806	47,630,957
Cash and cash equivalents			
Beginning of period	30,928,895	21,012,815	
End of period	$ 47,630,957	$ 46,439,621	$ 47,630,957

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

VANDA PHARMACEUTICALS INC.
(A Development Stage Enterprise)

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Business Organization and Presentation

Business organization

Vanda Pharmaceuticals Inc. (Vanda or the Company) is a biopharmaceutical company focused on the development and commercialization of small molecule therapeutics, with exclusive worldwide commercial rights to three product candidates in clinical development for various central nervous system disorders. Vanda commenced its operations on March 13, 2003. The Company s lead product candidate, iloperidone, is a compound for the treatment of schizophrenia and bipolar disorder. The Company expects to file a New Drug Application (NDA) for iloperidone in schizophrenia with the United States Food and Drug Administration (FDA) by the end of 2007. The Company s second product candidate, VEC-162, is a compound for the treatment of sleep and mood disorders, which previously demonstrated positive results from a Phase III clinical trial in transient insomnia. VEC-162 is also ready for Phase II trials for the treatment of depression. The Company expects to initiate dosing for the next Phase III trial of VEC-162 in chronic primary insomnia in the fourth quarter of 2007. The Company s third product candidate, VSF-173, is a compound for the treatment of excessive sleepiness. The Company expects to complete its first VSF-173 Phase II clinical trial in the fourth quarter of 2007.

Initial public and follow-on offerings

The Company completed its initial public offering in April 2006. The offering totaled 5,964,188 shares of common stock at a public offering price of $10.00 per share, resulting in net proceeds to the Company of approximately $53.3 million after deducting payments of underwriters discounts and commissions and offering expenses.

In January 2007 the Company completed its follow-on offering. The offering totaled 4,370,000 shares of common stock at a public offering price of $27.29 per share, resulting in net proceeds to the Company of approximately $111.3 million after deducting underwriting discounts and commissions and offering expenses.

Capital resources

Since its inception, the Company has devoted substantially all of its efforts to business planning, research and development, recruiting management and technical staff, acquiring operating assets, raising capital and market research. Accordingly, the Company is considered to be in the development stage as defined in Statement of Financial Accounting Standards (SFAS) No. 7, *Accounting and Reporting by Development Stage Enterprises*.

The Company s activities will necessitate significant uses of working capital throughout 2007 and beyond. Additionally, the Company s capital requirements will depend on many factors, including the success of the Company s research and development efforts, payments received under contractual agreements with other parties, if any, and the status of competitive products. The Company plans to continue financing its operations with cash received from financing activities and believes that its current capital resources will be sufficient to meet its current operating needs into mid-2008 and, after that time, the Company will require additional capital. In budgeting for our activities, we have relied on a number of assumptions, including assumptions that we will file an NDA for iloperidone in schizophrenia with the FDA by the end of 2007, that we will continue to expend funds in preparation of a commercial launch of iloperidone, that we will expend funds on the extended-release injectable formulation of iloperidone, that we will initiate dosing for the next Phase III trial of VEC-162 in chronic primary insomnia in the fourth quarter of 2007

and that this trial will be conducted in accordance with our expectations, that we will conduct our VSF-173 Phase II trial for excessive sleepiness in accordance with our expectations, that we will not engage in further in-licensing activities, that we will not receive any proceeds from potential partnerships, that we will not expend funds on the bipolar indication for

VANDA PHARMACEUTICALS INC.
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

iloperidone, that we will continue to evaluate pre-clinical compounds for potential development, that we will be able to continue the manufacturing of our product candidates at commercially reasonable prices, that we will be able to retain our key personnel, and that we will not incur any significant contingent liabilities.

The Company may need to raise additional funds more quickly if one or more of the above assumptions proves to be incorrect, if the Company chooses to expand its product development efforts more rapidly than presently anticipated or if the Company seeks to acquire additional product candidates. The Company may decide to raise additional funds even before they are needed if the conditions for raising capital are favorable. However, the Company may not be able to raise additional funds on acceptable terms, or at all. If the Company is unable to secure sufficient capital to fund its research and development activities, the Company may not be able to continue operations, or the Company may have to enter into collaboration agreements that could require the Company to share commercial rights to its products to a greater extent or at earlier stages in the drug development process than is currently intended.

Basis of presentation

The accompanying unaudited condensed consolidated financial statements of Vanda Pharmaceuticals Inc. have been prepared in accordance with accounting principles generally accepted in the United States and the rules and regulations of the Securities and Exchange Commission (SEC), for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the Company s consolidated financial statements for the year ended December 31, 2006 included in the Company s annual report on the Form 10-K. The financial information as of June 30, 2007 and for the periods of the three and six months ended June 30, 2007 and 2006 and for the period from March 13, 2003 (inception) to June 30, 2007, is unaudited, but in the opinion of management all adjustments, consisting only of normal recurring accruals, considered necessary for a fair statement of the results of these interim periods have been included. The condensed balance sheet data as of December 31, 2006 was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States.

The results of the Company s operations for any interim period are not necessarily indicative of the results that may be expected for any other interim period or for a full fiscal year. The financial information included herein should be read in conjunction with the consolidated financial statements and notes in the Company s annual report incorporated by reference in the Form 10-K for year ended December 31, 2006. The condensed consolidated financial statements include the accounts of the Company and its wholly-owned Singapore subsidiary. All inter-company balances and transactions have been eliminated.

2. Summary of Significant Accounting Policies

Cash and cash equivalents

For purposes of the condensed consolidated balance sheets and condensed consolidated statements of cash flows, cash equivalents represent highly-liquid investments with a maturity of three months or less at the date of purchase.

Marketable securities

The Company classifies all of its marketable securities as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses reported as a component of stockholders equity in accumulated other comprehensive loss. Interest income, amortization of premiums and accretion of discounts on marketable securities, and realized gains and losses on securities are included in interest income

VANDA PHARMACEUTICALS INC.
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

in the statements of operations. Marketable securities with a maturity of more than one year at the end of the period are classified as long-term securities.

Restricted cash

During 2005, in conjunction with the lease of the office and laboratory space in Rockville, MD, the Company provided the landlord with a letter of credit, which was collateralized with a deposit in the amount of $430,230. The deposit is recorded as non-current restricted cash at June 30, 2007 since the letter of credit is required until the lease expires in 2016.

Concentrations of credit risk

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents and marketable securities. The Company places its cash and cash equivalents and marketable securities with highly-rated financial institutions. At June 30, 2007, the Company maintained all of its cash and cash equivalents in three financial institutions. Deposits held with these institutions may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand, and the Company believes there is minimal risk of losses on such balances.

Stock-based compensation

The Company accounts for the stock-based compensation expenses in accordance with the Financial Accounting Standards Board (FASB) revised SFAS No. 123, *Share-Based Payment* (SFAS 123(R)). Accordingly, compensation costs for all stock-based awards to employees and directors are measured based on the grant date fair value of those awards and recognized over the period during which the employee is required to perform service in exchange for the award. The Company generally recognizes the expense over the award s vesting period.

For stock awards granted in 2006 and 2007, expenses are amortized under the accelerated attribution method. For stock awards granted prior to January 1, 2006, expenses are amortized under the accelerated attribution method for options that were modified after the original grant date and under the straight-line attribution method for all other options. As stock-based compensation expense recognized in the condensed consolidated statements of operations for the three and six months ended June 30, 2006 and 2007 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Pre-vesting forfeitures on the options granted during 2006 and 2007 were estimated to be approximately 2% based on the Company s historical experience.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Total employee stock-based compensation expense recognized during the three and six months ended June 30, 2007 and 2006 comprised of the following:

	Three Months Ended		Six Months Ended		Period from March 13, 2003 (Inception) to
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Research and development	$ 1,191,998	$ 148,071	$ 2,195,367	$ 290,774	$ 3,728,378
General and administrative	3,953,536	1,347,755	6,949,212	2,692,337	16,689,422
Stock-based compensation expense	$ 5,145,534	$ 1,495,826	$ 9,144,579	$ 2,983,111	$ 20,417,800
Stock-based compensation expense per basic and diluted share of common stock	$ 0.19	$ 0.08	$ 0.35	$ 0.31	

As of June 30, 2007, approximately $35.0 million of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of 3.0 years.

As of June 30, 2007, the Company had two equity incentive plans, the Second Amended and Restated Management Equity Plan (the 2004 Plan) and the 2006 Equity Incentive Plan (the 2006 Plan) that were adopted in December 2004 and April 2006, respectively. An aggregate of 1,233,756 shares were subject to outstanding options granted under the 2004 Plan as of June 30, 2007, and no additional options will be granted under this plan. As of June 30, 2007 there are 2,385,141 shares of the Company s common stock reserved under the 2006 Plan of which 1,606,928 shares were subject to outstanding options to employees and non-employees.

Options are subject to terms and conditions established by the compensation committee of the board of directors. None of the stock-based awards are classified as a liability as of June 30, 2007. Option awards have 10-year contractual terms and all options granted prior to December 31, 2006 and options granted to new employees vest and become exercisable on the first anniversary of the grant date with respect to the 25% of the option awards and the remaining 75% of the option awards vest and become exercisable monthly in equal installments thereafter over three years. Option awards granted to existing employees after December 31, 2006 vest and become exercisable monthly in equal installments over four years. The initial stock options granted to directors upon their election vest and become exercisable in equal monthly installments over a period of four years, while the subsequent annual stock option grants to directors vest and become exercisable in equal monthly installments over a period of one year. Certain option awards provide for accelerated vesting if there is a change in control of the Company.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model (Black-Scholes model) that uses the assumptions noted in the following table. Expected volatility rates are based on historical volatility of the common stock of comparable entities and other factors due to the lack of historic information of the Company s publicly traded common stock. The expected term of options granted is based on the transition approach provided by Staff Accounting Bulletin (SAB) No. 107 as the options meet the plain vanilla criteria required by this method. The risk-free interest rates are based on the U.S. Treasury yield for a period consistent with the expected term of the option in effect at the time of the grant. The Company has not paid dividends to its stockholders since its inception and does not plan to pay dividends in the foreseeable future.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Assumptions used in the Black-Scholes model for employee and director stock options granted during the six months ended June 30, 2007 and 2006 were as follows:

	Six Months Ended	
	June 30, 2007	**June 30, 2006**
Expected dividend yield	0%	0%
Expected volatility	71% - 73%	70%
Expected term (years)	6.25	5
Weighted average risk-free rate	4.84%	4.50%

A summary of option activity for the 2004 Plan is presented below:

	Number of Shares	**Weighted Average Exercise Price at Grant Date**	**Weighted Average Remaining Term (Years)**	**Aggregate Intrinsic Value**
Outstanding at December 31, 2006	1,347,205	$ 1.69		
Forfeited	(1,891)	1.47		
Exercised	(111,558)	0.71		$ 2,587,112
Outstanding at June 30, 2007	1,233,756	$ 1.78	8.25	$ 22,802,743
Exercisable at June 30, 2007	467,583	$ 1.68	8.10	$ 8,857,646

A summary of option activity for the 2006 Plan is presented below:

	Number of Shares	**Weighted Average Exercise Price at Grant Date**	**Weighted Average Remaining Term (Years)**	**Aggregate Intrinsic Value**
Outstanding at December 31, 2006	359,527	$ 20.21		

Granted	1,256,801		29.60		
Forfeited	(9,400)		27.41		
Outstanding at June 30, 2007	1,606,928	$	27.51	9.56	$ 1,314,695
Exercisable at June 30, 2007	131,264	$	28.91	9.58	$ 83,168

The weighted average grant-date fair value of options granted during the six months ended June 30, 2007 was $20.38 per share. For the six months ended June 30, 2007 and 2006 the Company received a total of $79,587 and $294, respectively, in cash from options exercised under the stock-based arrangements.

Equity instruments issued to non-employees

The equity instruments issued to non-employees in exchange for services are recorded at the fair value of the equity instruments on the measurement date. The measurement of expense is subject to periodic adjustment as the underlying equity instruments vest and the performance by the third party is complete. The Company recognizes the fair value of non-employee equity instruments in the same periods and in the same manner as if the Company had paid cash for the services.

As of June 30, 2007 an aggregate of 35,625 shares were subject to outstanding options granted to non-employees under the 2004 Plan and 2006 Plan of which 29,837 options are subject to vesting. Total non-

VANDA PHARMACEUTICALS INC.
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

employee equity-based compensation expense, recognized during the three and six months ended June 30, 2007 and 2006 was comprised of the following:

	Three Months Ended		Six Months Ended		Period from March 13, 2003 (Inception) to
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Research and development	$ 38,193	$ 1,659	$ 89,800	$ 34,767	$ 129,288
General and administrative	31,962		89,285		89,285
Stock-based compensation expense	$ 70,155	$ 1,659	$ 179,085	$ 34,767	$ 218,573

Accrued expenses

Management is required to estimate accrued expenses as part of the process of preparing financial statements. The estimation of accrued expenses involves identifying services that have been performed on the Company s behalf, and then estimating the level of service performed and the associated cost incurred for such services as of each balance sheet date in the financial statements. Examples of estimated accrued expenses include professional service fees, such as lawyers and accountants, contract service fees, such as amounts paid to clinical monitors, data management organizations and investigators in conjunction with clinical trials, fees paid to contract manufacturers in conjunction with the production of clinical materials, and fees paid for marketing and other commercialization activities. Pursuant to management s assessment of the services that have been performed on clinical trials and other contracts, the Company recognizes these expenses as the services are provided. Such management assessments include, but are not limited to: (1) an evaluation by the project manager of the work that has been completed during the period, (2) measurement of progress prepared internally and/or provided by the third-party service provider, (3) analyses of data that justify the progress, and (4) management s judgment.

Research and development expenses

The Company s research and development expenses consist primarily of fees paid to third parties in connection with the services they provide for our clinical trials, costs of contract manufacturing services, license fees, costs of materials used in clinical trials and research and development, depreciation of capital resources used to develop our products, all related facilities costs, and salaries, other related costs and stock-based compensation related to our research and development personnel. We expense research and development costs as they are incurred, including payments made to date under our license agreements. Manufacturing-related costs are also included in research and development expenses as we do not yet have FDA approval for any of our product candidates. Costs related to our acquisitions of intellectual property have been expensed as incurred since the underlying technology associated with

these acquisitions were made in connection with the Company s research and development efforts and have no alternative future use.

General and administrative expenses

General and administrative costs consist primarily of salaries, other related costs and stock-based compensation for personnel serving executive, finance, accounting, information technology and human resource functions, facility costs not otherwise included in research and development expenses, insurance costs and professional fees for legal, accounting and other professional services. General and administrative costs also include third party expenses incurred to support business development, marketing and other business activities related to our product candidate iloperidone, in anticipation of its commercial launch.

VANDA PHARMACEUTICALS INC.
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Income taxes

The Company accounts for income taxes under the liability method in accordance with provisions of SFAS No. 109, *Accounting for Income Taxes,* (SFAS 109) which requires companies to account for deferred income taxes using the asset and liability method. Under the asset and liability method, current income tax expense or benefit is the amount of income taxes expected to be payable or refundable for the current year. A deferred income tax asset or liability is recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credits and loss carryforwards. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Tax rate changes are reflected in income during the period such changes are enacted. Changes in ownership may limit the amount of net operating loss carryforwards that can be utilized in the future to offset taxable income.

Segment information

Management has determined that the Company operates in one business segment which is the development and commercialization of pharmaceutical products.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates that affect the reported amounts of assets and liabilities at the date of the financial statements, disclosure of contingent assets and liabilities, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Deferred grant revenue

Vanda Singapore entered into an agreement with the Economic Development Board of Singapore (EDB) to provide a grant for a development project. During 2005, the Company received its first reimbursement under the agreement. Given that the Company has not met all of the conditions attached to the grant expected to be met to date and therefore under certain conditions EDB may reclaim funds paid to date, the payment has been recorded as deferred grant revenue at June 30, 2007.

Recent accounting pronouncements

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (SFAS 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. SFAS 157 outlines a common definition of fair value and the new standard intends to make the measurement of fair value more consistent and comparable and improve disclosures about those measures. The Company will need to adopt SFAS 157 for financial statements issued for fiscal years beginning after November 15, 2007. While the Company continues to evaluate the impact of SFAS 157, this pronouncement is not expected to have significant impact on its results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115* (SFAS 159). According to this standard the entities will now be permitted to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis (the fair value option). SFAS 159 is effective for fiscal years beginning after November 15, 2007. While the Company continues to evaluate the impact of

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SFAS 159, this pronouncement is not expected to have significant impact on its results of operations and financial condition.

3. Earnings per Share

Net loss attributable to common stockholders per share is calculated in accordance with SFAS No. 128, *Earnings per Share* and SAB No. 98. Basic earnings per share (EPS) is calculated by dividing the net income or loss attributable to common stockholders by the weighted average number of shares of common stock outstanding, reduced by the weighted average unvested shares of common stock subject to repurchase.

Diluted EPS is computed by dividing the net income or loss attributable to common stockholders by the weighted average number of other potential common stock outstanding for the period. Other potential common stock includes the Company s Series A Preferred Stock and Series B Preferred Stock outstanding prior to the consummation of the Company s initial public offering, stock options and warrants to purchase common stock, but only to the extent that their inclusion is dilutive. The Company incurred a net loss in all periods presented, causing inclusion of any potentially dilutive securities to have an anti-dilutive affect, resulting in dilutive loss per share attributable to common stockholders and basic loss per share attributable to common stockholders being equivalent.

	Three Months Ended		Six Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Numerator:				
Net loss	$ (15,985,023)	$ (21,373,084)	$ (31,377,783)	$ (39,495,534)
Denominator:				
Weighted average shares of common stock outstanding	26,587,482	19,222,805	26,001,078	9,661,170
Weighted average unvested shares of common stock subject to repurchase	(20,322)	(39,145)	(22,641)	(44,823)
Denominator for basic and diluted net loss per share	26,567,160	19,183,660	25,978,437	9,616,347
Basic and diluted net loss per share applicable to common stockholders	$ (0.60)	$ (1.11)	$ (1.21)	$ (4.11)
Anti-dilutive securities not included in diluted net loss per share calculation:				
Options to purchase common stock	2,840,684	1,572,385	2,840,684	1,572,385

Upon consummation of the initial public offering on April 12, 2006, all shares of the Company s Series A Preferred Stock and Series B Preferred Stock were converted into an aggregate of 15,794,632 shares of common stock. Additionally, the holders of the warrants to purchase 50,335 shares of common stock exercised their warrants upon the Company s initial public offering.

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4. Marketable Securities

The following is a summary of the Company s available-for-sale marketable securities as of June 30, 2007:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
U.S. Treasury and government agencies	$ 13,939,860	$	$ (1,689)	$ 13,938,171
U.S. corporate debt	52,813,493	28,502	(14,354)	52,827,641
U.S. asset-based securities	5,262,454	2,925		5,265,379
	$ 72,015,807	$ 31,427	$ (16,043)	$ 72,031,191

The following is a summary of the Company s available-for-sale marketable securities as of December 31, 2006:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
U.S. corporate debt	$ 941,970	$ 36	$ (25)	$ 941,981
	$ 941,970	$ 36	$ (25)	$ 941,981

5. Prepaid expenses, deposits and other current assets

The following is a summary of the Company s prepaid expenses, deposits and other current assets:

	June 30, 2007	December 31, 2006
Deposits with vendors	$ 820,000	$ 820,000
Prepaid insurance	710,352	337,332
Prepaid research and development expenses	598,934	185,229
Accrued interest income	340,989	97,575
Other prepaid expenses	820,236	332,400
Prepaid follow-on offering costs		69,064
Other receivables	15,042	107,866

	$ 3,305,553	$ 1,949,466

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6. Property and Equipment

Property and equipment at cost:

	Estimated Useful Life (Years)	June 30, 2007	December 31, 2006
Laboratory equipment	5	$ 1,683,173	$ 1,675,375
Computer equipment	3	935,819	741,404
Furniture and fixtures	7	177,965	169,549
Leasehold improvements	10	737,182	736,518
		3,534,139	3,322,846
Less accumulated depreciation and amortization		(1,763,573)	(1,463,142)
		$ 1,770,566	$ 1,859,704

Depreciation and amortization expense for the six months ended June 30, 2007 was $293,660, for the six months ended June 30, 2006 was $247,860 and for the period from March 13, 2003 (inception) to June 30, 2007 was $1,725,686.

7. Accrued Expenses

Accrued expenses consist of the following:

	June 30, 2007	December 31, 2006
Accrued research and development expenses	$ 4,380,207	$ 4,552,050
Bonus accrual	464,672	1,084,512
Accrued professional fees	913,253	329,177
Employee benefits	237,787	78,656
Lease abandonment	246,598	232,388
Other accrued expenses	47,647	46,025
	$ 6,290,164	$ 6,322,808

8. Commitments and Contingencies

Singapore research facility

In May 2007, the Company initiated a plan to move all of its operations out of Singapore and consolidate all of its discovery research activities in its Rockville, Maryland research facility by the end of 2007. As the timing and the amount of the restructuring expenses were not known as of June 30, 2007, the Company did not record any restructuring charge during the six-month period ended June 30, 2007. The restructuring expenses will likely include employee severance and relocation expenses, certain minimal lease termination expenses and other related costs, the total of which is not expected to have significant impact on the financial results of the Company.

Operating leases

The Company has commitments totaling approximately $4.4 million under operating real estate leases for its current and former headquarters located in Rockville, Maryland, expiring in 2016 and 2008, respectively. In

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connection with the consolidation of the Company s research activities, the Company terminated its Singapore lease and expects to vacate its Singapore premises no later than by the end of 2007. Additionally, during the second quarter of 2007, the Company also exercised an option to lease additional space in its current Rockville, Maryland headquarters and is currently negotiating the terms of the lease.

Guarantees and indemnifications

The Company has entered into a number of standard intellectual property indemnification agreements in the ordinary course of its business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company s business partners or customers, in connection with any U.S. patent or any copyright or other intellectual property infringement claim by any third party with respect to the Company s products. The term of these indemnification agreements is generally perpetual from the date of execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. Since inception, the Company has not incurred costs to defend lawsuits or settle claims related to these indemnification agreements. The Company also indemnifies its officers and directors for certain events or occurrences, subject to certain limits. The Company believes that the fair value of the indemnification agreements is minimal, and accordingly the Company has not recognized any liabilities relating to these agreements as of June 30, 2007.

Licensing agreements

The Company s rights to develop and commercialize the clinical-stage product candidates are subject to the terms and conditions of licenses granted to the Company by other pharmaceutical companies.

Iloperidone. The Company acquired exclusive worldwide rights to patents for iloperidone through a sublicense agreement with Novartis. A predecessor company of sanofi-aventis, Hoechst Marion Roussel, Inc. (HMRI), discovered iloperidone and completed early clinical work on the compound. In 1996, following a review of its product portfolio, HMRI licensed its rights to the iloperidone patents to Titan Pharmaceuticals, Inc. on an exclusive basis. In 1997, soon after it had acquired its rights, Titan sublicensed its rights to iloperidone on an exclusive basis to Novartis. In June 2004, the Company acquired exclusive worldwide rights to these patents to develop and commercialize iloperidone through a sublicense agreement with Novartis. In partial consideration for this sublicense, the Company paid Novartis an initial license fee of $500,000 and is obligated to make future milestone payments to Novartis of less than $100 million in the aggregate (the majority of which are tied to sales milestones), as well as royalty payments to Novartis at a rate which, as a percentage of net sales, is in the mid-twenties. The Company expects to meet a milestone in 2007 under this license agreement, for which the Company would be obligated to make a license payment of $5 million.

The rights with respect to the patents to develop and commercialize iloperidone may terminate, in whole or in part, if the Company fails to meet certain development or commercialization milestones relating to the time it takes for the Company to launch iloperidone commercially following regulatory approval, and the time it takes for the Company to receive regulatory approval following the submission of an NDA or equivalent foreign filing. Additionally, the Company s rights may terminate in whole or in part if the Company does not meet certain other obligations under the sublicense agreement to make royalty and milestone payments, if the Company fails to comply with requirements in the sublicense agreement regarding its financial condition, or if the Company does not abide by certain restrictions in

the sublicense agreement regarding other development activities.

VEC-162. In February 2004, the Company entered into a license agreement with Bristol-Myers Squibb (BMS) under which the Company received an exclusive worldwide license under certain patents and patent applications, and other licenses to intellectual property, to develop and commercialize VEC-162. In partial

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consideration for the license, the Company paid BMS an initial license fee of $500,000 and is obligated to make future milestone payments to BMS of less than $40 million in the aggregate (the majority of which are tied to sales milestones) as well as royalty payments based on the net sales of VEC-162 at a rate which, as a percentage of net sales, is in the low teens. The Company is also obligated under this agreement to pay BMS a percentage of any sublicense fees, upfront payments and milestone and other payments (excluding royalties) that the Company receives from a third party in connection with any sublicensing arrangement, at a rate which is in the mid-twenties. The Company has agreed with BMS in the license agreement for VEC-162 to use commercially reasonable efforts to develop and commercialize VEC-162 and to meet certain milestones in initiating and completing certain clinical work. During March 2006, the Company met its first milestone relating to the initiation of the Phase III clinical trial for VEC-162 and recorded a license fee expense of $1,000,000.

BMS holds certain rights with respect to VEC-162 in the license agreement. If the Company has not agreed to one or more partnering arrangements to develop and commercialize VEC-162 in certain significant markets with one or more third parties after the completion of the Phase III program, BMS has the option to exclusively develop and commercialize VEC-162 on its own on pre-determined financial terms, including milestone and royalty payments. If the Company seeks a co-promotion agreement for VEC-162, BMS has a right of first negotiation to enter into such an agreement with the Company.

Either party may terminate the VEC-162 license agreement under certain circumstances, including a material breach of the agreement by the other. In the event that BMS has not exercised its option to reacquire the rights to VEC-162 and the Company terminates the license, or if BMS terminates the license due to the Company s breach, all rights licensed and developed by the Company under this agreement will revert or otherwise be licensed back to BMS on an exclusive basis.

VSF-173. In June 2004, the Company entered into a license agreement with Novartis under which the Company received an exclusive worldwide license to develop and commercialize VSF-173. In consideration for the license, the Company paid Novartis an initial license fee of $500,000. The Company is also obligated to make future milestone payments to Novartis of less than $50 million in the aggregate (the majority of which are tied to sales milestones) and royalty payments at rates which, as a percentage of net sales, range from the low-to-mid teens. In March 2007, the Company met its first milestone under this license agreement relating to the initiation of the Phase II clinical trial for VSF-173, and recorded a license fee expense of $1,000,000.

Novartis has the right to co-develop and exclusively commercialize VSF-173 on its own after the completion of Phase II and Phase III programs in exchange for certain milestones and royalty payments. In the event that Novartis chooses not to exercise either of these options and the Company decides to enter into a partnering arrangement to commercialize VSF-173, Novartis has a right of first refusal to negotiate such an agreement with the Company, as well as a right to submit a last matching counteroffer regarding such an agreement. In addition, the rights with respect to VSF-173 may terminate, in whole or in part, if the Company fails to meet certain development and commercialization milestones described in the license agreement relating to the time it takes the Company to complete the development work on VSF-173. These rights may also terminate in whole or in part if the Company fails to make royalty or milestone payments or if the Company does not comply with requirements in the license agreement regarding its financial condition. In the event of an early termination of the license agreement, all rights licensed and developed by the Company under this agreement may revert back to Novartis.

Future license payments. No amounts were recorded as liabilities nor were any other contractual obligations relating to the license agreements included in the condensed consolidated financial statements as of June 30, 2007, since the amounts, timing and likelihood of these future payments are unknown and will

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depend on the successful outcome of future clinical trials, regulatory filings, favorable FDA regulatory approvals, growth in product sales and other factors.

Research and development and marketing agreements

The Company entered into agreements with several organizations to provide services relating to clinical development, clinical manufacturing activities and marketing services under fee service arrangements. The Company s current agreements for these services may be terminated on no more than 60 days notice without incurring additional charges, other than charges for work completed but not paid for through the effective date of termination and other costs incurred by the Company s contractors in closing out work in progress as of the effective date of termination.

9. Income Taxes

On January 1, 2007, the Company adopted the provisions of Financial Standards Accounting Board Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. The adoption of FIN No. 48 did not have a material effect on our financial position or results of operations. In addition, there are no uncertain tax positions whose resolution in the next 12 months is expected to materially affect operating results. The Company accounts for income taxes using the asset and liability method. Deferred income taxes are recognized by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain.

The Company has not recorded any tax provision or benefit for the six months ended June 30, 2007 or 2006, except for an estimated tax expense resulting from the research and development agreement with the Company s subsidiary in Singapore. The Company has provided a valuation allowance for the full amount of its net deferred tax assets since realization of any future benefit from deductible temporary differences and net operating loss cannot be sufficiently assured at June 30, 2007 and December 31, 2006. Under the Tax Reform Act of 1986, the amounts of and benefits from the operating loss carryforwards may be impaired in certain circumstances. Events which cause limitations in the amount of net operating losses that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined, over a three year period.

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

Forward Looking Statements

Various statements in this report are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Words such as, but not limited to, believe, expect, anticipate, estimate, intend plan, targets, likely, will, would, and could, and similar expressions or words, identify forward-looking stater Such forward-looking statements are based upon current expectations that involve risks, changes in circumstances, assumptions and uncertainties. Vanda is at an early stage of development and may not ever have any products that generate significant revenue. Important factors that could cause actual results to differ materially from those reflected in Vanda s forward-looking statements include, among others:

- *delays in the completion of our clinical trials;*
- *a failure of our product candidates to be demonstrably safe and effective;*
- *a failure to obtain regulatory approval for our products or to comply with ongoing regulatory requirements;*
- *a lack of acceptance of our product candidates in the marketplace, or a failure to become or remain profitable;*
- *our inability to obtain the capital necessary to fund our research and development activities;*
- *our failure to identify or obtain rights to new product candidates;*
- *a failure to develop or obtain sales, marketing and distribution resources and expertise or to otherwise manage our growth;*
- *a loss of any of our key scientists or management personnel;*
- *losses incurred from product liability claims made against us;*
- *a loss of rights to develop and commercialize our products under our license and sublicense agreements; and*
- *the increased expenses and administrative workload associated with being a public company.*

The information in this report is provided only as of the date of this report, and Vanda undertakes no obligation to update any forward-looking statements contained in this report on account of new information, future events, or otherwise, except as required by law.

Forward-looking statements, therefore, should be considered in light of all of the information included or referred to in this report, including the Risk Factors section set forth as Item 1A of Part II of this report. You should also read the following discussion and analysis of financial condition and results of operations together with our condensed consolidated financial statements and related notes included elsewhere in this report.

Our Business

We are a biopharmaceutical company focused on the development and commercialization of clinical-stage product candidates for central nervous system disorders, with exclusive worldwide commercial rights to three product candidates in clinical development. Our lead product candidate, iloperidone, is a compound for the treatment of schizophrenia and bipolar disorder and in December 2006 we announced positive results from our Phase III trial of iloperidone for schizophrenia. Our second product candidate, VEC-162, is a compound for the treatment of sleep and mood disorders, which previously demonstrated positive results in a Phase III clinical trial for transient insomnia. VEC-162 is also ready for Phase II trials for the treatment of depression. Our third product candidate, VSF-173, is a compound for the treatment of excessive sleepiness and we expect to complete our first VSF-173 Phase II clinical trial in the fourth quarter of 2007.

We expect to file a New Drug Application (NDA) for iloperidone in schizophrenia with the United States Food and Drug Administration (FDA) by the end of 2007. We will have to conduct additional trials for VEC-162 prior to our filing of an NDA for VEC-162, and we expect to begin dosing for the next Phase III trial of VEC-162 in chronic primary insomnia in the fourth quarter of 2007. Assuming successful outcomes of our clinical trials and approval by the FDA, we may commercialize iloperidone and VSF-173 with our own sales force in the U.S., and expect to commercialize VEC-162 through a partnership with a global pharmaceutical company, although we have not yet identified such a global partner.

We are a development stage enterprise and have accumulated net losses of approximately $131.2 million since the inception of our operations through June 30, 2007. We have no product revenues to date and have no approved products for sale. Since inception we have devoted substantially all of our efforts to business planning, research and development, recruiting management and technical staff, acquiring operating assets, raising capital and conducting market research. Our future operating results will depend largely on our ability to successfully develop and commercialize our lead product candidates, iloperidone and VEC-162, and on the progress of other product candidates currently in our research and development pipeline. The results of our operations will vary significantly from year-to-year and quarter-to-quarter and depend on a number of factors, including risks related to our business, risks related to our industry, and other risks which are detailed in the Risk factors section of this quarterly report on Form 10-Q.

We completed our initial public offering in April 2006. The offering totaled 5,964,188 shares of common stock at a public offering price of $10.00 per share, resulting in net proceeds to the Company of approximately $53.3 million, after deducting underwriters discounts and commissions as well as offering expenses.

In January 2007 we completed our follow-on offering. The offering totaled 4,370,000 shares of common stock at the public offering price of $27.29 per share, resulting in net proceeds to the Company of approximately $111.3 million after deducting underwriting discounts and commissions and offering expenses.

Based on our current operating plans, we believe that our existing cash, cash equivalents and marketable securities, will be sufficient to meet our anticipated operating needs through mid-2008, and after that time we will require additional capital. In budgeting for our activities, we have relied on a number of assumptions, including assumptions that we will file an NDA for iloperidone in schizophrenia with the FDA by the end of 2007, that we will continue to expend funds in preparation of a commercial launch of iloperidone, that we will expend funds on the extended-release injectable formulation of iloperidone, that we will initiate dosing for the next VEC-162 trial in chronic primary insomnia in the fourth quarter of 2007 and that this trial will be conducted in accordance with our expectations, that we will conduct our VSF-173 Phase II trial for excessive sleepiness in accordance with our expectations, that we will not engage in further in-licensing activities, that we will not receive any proceeds from potential partnerships, that we will not expend funds on the bipolar indication for iloperidone, that we will continue to evaluate pre-clinical compounds for potential development, that we will be able to continue the manufacturing of our product candidates at commercially reasonable prices, that we will be able to retain our key personnel, and that we will not incur any significant contingent liabilities.

We may need to raise additional funds more quickly if one of the above assumptions proves to be incorrect, if we choose to expand our product development efforts more rapidly than presently anticipated or seek to acquire additional product candidates, and we may also decide to raise additional funds even before they are needed if the conditions for raising capital are favorable. We may seek to sell additional equity or debt securities or to obtain a bank credit facility. The sale of additional equity or debt securities, if convertible, could result in dilution to our stockholders. The incurrence of indebtedness would result in increased fixed obligations and could also result in covenants that would restrict our operations.

Iloperidone

Iloperidone is our product candidate under development to treat schizophrenia and bipolar disorder. Iloperidone has successfully completed its Phase III trial in schizophrenia. We are also developing a 4-week injectable formulation of iloperidone, for which we already have early Phase II data from a study previously conducted by Novartis. We are planning to conduct additional clinical work on this formulation in 2008.

From inception to June 30, 2007, we incurred approximately $55.8 million in research and development costs directly attributable to our development of iloperidone. We remain on track to file our NDA for iloperidone in schizophrenia by the end of this year.

We expect to increase our pre-launch commercial activities relating to iloperidone, and we expect to start marketing iloperidone commercially in early 2009. However, the time it takes to receive cash inflows from the sale of iloperidone is highly dependent on facts and circumstances that we may not be able to control and are subject to a number of risks. For example, delays in the approval process and subsequent commercial launch of iloperidone following our filing may occur if the FDA fails to attend to our filing in a timely manner or requires further data to approve iloperidone. Please see the Risk factors section of this quarterly report on Form 10-Q for a more detailed discussion of these and other risks.

We also continue to progress with the development of our 4-week injectable formulation of iloperidone, for which we already have early Phase II data from a study previously conducted by Novartis. We are planning to conduct additional clinical work in 2008.

VEC-162

VEC-162 is our product candidate under development to treat insomnia and depression. VEC-162 is a melatonin receptor agonist that works by adjusting the human body clock of circadian rhythm. VEC-162 has successfully completed a Phase III trial in transient insomnia.

From inception to June 30, 2007, we incurred approximately $27.0 million in direct research and development costs of VEC-162. We believe that we will have to conduct additional trials to receive FDA approval of VEC-162. We expect to initiate dosing in the fourth quarter of 2007 of our next Phase III clinical trial of VEC-162, to evaluate the safety and efficacy of VEC-162 in chronic primary insomnia. The trial is expected to be a randomized, double-blind, and placebo-controlled study, and will enroll approximately 400 patients. The trial will measure time to fall asleep and sleep maintenance, as well as next-day performance and mood.

VSF-173

In April 2007, we initiated the Phase II clinical trial for our product candidate VSF-173 in excessive sleepiness. The trial is a randomized, double-blind, placebo-controlled study to investigate the efficacy and safety of three oral doses of VSF-173 for the treatment of induced excessive sleepiness in approximately 60 healthy male and female volunteers. The primary endpoint of the study is the difference from placebo on the Maintenance of Wakefulness Test (MWT), a standard measure of sleepiness. As trial enrollment is ahead of schedule, we expect to announce the results in the fourth quarter of 2007.

Excessive sleepiness is a common symptom that can significantly impair a person s ability to function. The effects of excessive sleepiness range from mild sleepiness to unrecognized episodes of microsleeps and uncontrollable sleep attacks. Excessive sleepiness is a symptom of many disorders, including obstructive sleep apnea, narcolepsy, shift worker sleep disorder, Parkinson s disease and Alzheimer s disease.

From inception to June 30, 2007, we incurred approximately $4.9 million in direct research and development costs related to VSF-173, including a milestone license fee of $1.0 million paid upon the initiation of our first Phase II clinical trial.

Research and development expenses

The Company s research and development expenses consist primarily of fees paid to third parties in connection with the services they provide for our clinical trials, costs of contract manufacturing services, license fees, costs of materials used in clinical trials and research and development, depreciation of capital resources used to develop our products, all related facilities costs, and salaries, benefits and stock-based compensation expenses related to our research and development personnel. We expense research and development costs as they are incurred, including payments made to date under our license agreements. We believe that significant investment in product development is a competitive necessity and plan to continue

these investments in order to realize the potential of our product candidates and pharmacogenetics and pharmacogenomics expertise. From inception through June 30, 2007, we incurred research and development expenses in the aggregate of approximately $99.2 million, including stock-based compensation expenses of approximately $3.7 million. We expect our research and development expenses to increase as we continue to develop our product candidates. We also expect to incur substantial licensing costs in the future, as we continue our efforts to develop our product candidates and to evaluate potential in-license product candidates.

The following table summarizes our product development initiatives for the three and six months ended June 30, 2007 and 2006 and the period from March 13, 2003 (inception) to June 30, 2007. Included in this table are the research and development expenses recognized in connection with our product candidates in clinical development. Included in Other product candidates are the costs directly related to research initiatives for all other product candidates.

	Three Months Ended		Six Months Ended		Period from March 13, 2003 (Inception) to
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Direct project costs(1)					
Iloperidone	$ 5,072,000	$ 14,611,000	$ 10,394,000	$ 26,283,000	$ 55,770,000
VEC-162	3,233,000	3,293,000	6,028,000	6,046,000	27,047,000
VSF-173	811,000	336,000	2,295,000	635,000	4,864,000
Other product candidates	446,000	355,000	906,000	646,000	3,940,000
Total direct product costs	9,562,000	18,595,000	19,623,000	33,610,000	91,621,000
Indirect project costs(1)					
Facility	151,000	144,000	282,000	317,000	1,366,000
Depreciation	115,000	122,000	225,000	224,000	1,488,000
Other indirect overhead	366,000	239,000	656,000	437,000	4,726,000
Total indirect expenses	632,000	505,000	1,163,000	978,000	7,580,000
Total research and development expenses	$ 10,194,000	$ 19,100,000	$ 20,786,000	$ 34,588,000	$ 99,201,000

(1) Many of our research and development costs are not attributable to any individual project because we share resources across several development projects. We record direct costs, including personnel costs and related benefits and stock-based compensation, on a project-by-project basis. We record indirect costs that support a number of our research and development activities in the aggregate.

General and administrative expenses

General and administrative expenses consist primarily of salaries, other related costs and stock-based compensation expenses for personnel serving executive, finance, accounting, information technology and human resource functions, facility costs not otherwise included in research and development expenses, insurance costs and professional fees for

legal, accounting and other professional services. General and administrative costs also include third party expenses incurred to support business development, marketing and other business activities related to our product candidate iloperidone in anticipation of its commercial launch. We expect that our general and administrative expenses will increase as we continue to prepare the commercial launch of our lead product candidates, add personnel and fulfill our reporting obligations applicable to public companies. From inception through June 30, 2007, we incurred general and administrative expenses in the aggregate of approximately $37.9 million, including stock-based compensation expenses of approximately $16.7 million.

Critical Accounting Policies

The preparation of our condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of our financial statements as well as the reported revenues and expenses during the reported periods. We base our estimates on historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our significant accounting policies are described in the notes to our audited consolidated financial statements for the year ended December 31, 2006 included in our annual report on the Form 10-K. However, we believe that the following critical accounting policies relating to accrued expenses and stock-based compensation expense are important to understanding and evaluating our reported financial results, and we have accordingly included them in this report.

Accrued expenses

As part of the process of preparing financial statements we are required to estimate accrued expenses. This process involves identifying services that have been performed on our behalf and estimating the level of service performed and the associated cost incurred for such service as of each balance sheet date in our financial statements. Examples of estimated accrued expenses include professional service fees, such as lawyers and accountants, contract service fees such as amounts paid to clinical monitors, data management organizations and investigators in conjunction with clinical trials, fees paid to contract manufacturers in conjunction with the production of clinical materials and fees paid for marketing and other commercialization activities. Pursuant to our assessment of the services that have been performed on clinical trials and other contracts, we recognize the expenses as the services are provided. Such assessments include, but are not limited to: (1) an evaluation by the project manager of the work that has been completed during the period, (2) measurement of progress prepared internally and/or provided by the third-party service provider, (3) analyses of data that justify the progress, and (4) management s judgment. In the event that we do not identify certain costs that have begun to be incurred or we in the quarter ended March 31, 2006.

- We closed on the acquisition of a 25% working interest in approximately 59,000 net acres in the Williston Basin located in North Dakota.

- We entered into a $50 million revolving credit facility (the Credit Facility) with BNP Paribas as administrative agent, sole lead arranger, and sole book runner.

- We hired two new senior executives: a Chief Financial Officer and a Vice President of Production.

Results of Operations for the Three Months Ended June 30, 2006

We had a net loss for the three months ended June 30, 2006, of $1,526,345, which is $142,835 less than the net loss from for the same period in 2005. The decreased loss was due primarily to an increase in gas revenue associated with higher levels of gas production from the prior period when we had yet to commence producing activities in the Rocky Mountains.

During the three months ended in June 30, 2006, oil and gas production net to our interest totaled 131,343 mcf resulting in $650,234 in oil and gas sales, at an average price of $4.95 per mcf after a total deduction of $101,797 for gathering, fuel,

transportation and marketing expenses for the quarter. There were no comparative revenues in for the three months ended June 30, 2005, as we had not yet commenced operations.

Lease operating expenses and production taxes expenses for the three-month period ended June 30, 2006, were $114,410 and $11,832, respectively, (or a total of 19% of revenues) net to us resulting in operating income from oil and gas activities of $523,992 before depreciation and depletion, exploration costs, general and administrative expenses, and other income. There were no comparative expenses during the corresponding three month period ended June 30, 2005, as we had not yet commenced formal operations.

During the second quarter of 2006, general and administrative expense increased from $1,581,743 during 2005 to $1,705,942 which is primarily due to an increase in non-cash charges as described in greater detail below. Significant changes in general and administrative expenses for the three months ended June 30, 2006, compared to 2005 include:

- An increase in compensation expense increased of approximately $995,966, which increase was due primarily to $706,989 of non-cash compensation accruals of stock-based grants as a result of the performance estimates associated with our long-term incentive plan and our adoption of Statement of Financial Accounting Standard 123R Share-Based Payment, effective as of January 1, 2006. Our compensation increased as a result of an increase in the number of employees from 2005 associated with the growth in our operations.

- Stock transfer and listing fees increased $52,295 from the prior year due to the shelf registrations.

- Travel expenses increased by approximately $28,000 as a result of additional staff relative to 2005, which additional staff was responsible for overseeing increased operations relative to the comparable period.

During the three-month period ended June 30, 2006; certain general and administrative expenses were lower than in the prior year three-month period:

- Legal and accounting, decreased by approximately $832,633 from the prior year period in 2005 as a result of decreased legal and accounting costs associated with non cash compensation of approximately $798,000 related to stock awards made in 2005 to consultants providing legal and accounting services to the Company.

- Insurance-related costs were approximately $5,000 lower from the prior year period as a result of lower D&O premiums coupled with reduced premiums as a result of the closing of all satellite offices.

During the second quarter of 2006, we incurred $74,745 in exploration expenses, primarily on our DJ Basin properties, relating to delay rentals.

Depreciation and depletion expense increased from $4,953 in the second quarter in 2005 to $330,173 in the same quarter in 2006 due to the gas production in 2006 compared to none in 2005.

Other income in 2006 includes interest income from the cash balances maintained.

Results of Operations for the Six Months Ended June 30, 2006

We had a net loss for the six months ended June 30, 2006, of $2,788,971, which is $439,796 more than the net loss from for the same period in 2005. As described in further detail below, the increased loss was due primarily to accruals of non-cash compensation charges.

In the six months ended in June 30, 2006, oil and gas production net to our interest totaled 176,533 mcf resulting in $940,483 in oil and gas sales, at an average price of $5.33 per mcf after a total deduction of $144,578 for gathering, fuel, transportation and marketing expenses for the first six months of 2006. There were no comparative revenues in respect of the six months ended June 30, 2005, as we had not yet commenced operations.

Lease operating expenses and production taxes for the six-month period ended June 30, 2006, were $148,198 and $19,850, respectively (or a total of 18% of revenues) net to us resulting in operating income from oil and gas activities of $772,435 before depreciation and depletion, exploration costs, general and administrative expenses, and other income. There were no comparative expenses during the corresponding six-month period ended June 30, 2005, as we had not yet commenced formal operations.

During the six months ended June 30, 2006, general and administrative expense increased from $2,273,740 for the comparable period during 2005 to $3,048,745. Significant changes in general and administrative expenses for the six months ended June 30, 2006, compared to 2005 include:

- Compensation expense increased approximately $1.6 million, which increase was due primarily to $1,196,013 million of non-cash compensation accruals of stock-based grants as a result of the implementation of our long-term incentive plan and our adoption of Statement of Financial Accounting Standard 123R Share-Based Payment, effective as of January 1, 2006 and a increase in the number of employees associated with our growth between 2005 and 2006.

- Stock transfer and listing fees increased $75,729 from the prior year due to the shelf registrations.

- Office expenses increased by approximately $98,000 due to larger office space and office supplies due to increased activity.

During the six-month period ended June 30, 2006; certain general and administrative expenses were lower than in the prior year six-month period:

- Legal and accounting, decreased by approximately $895,898 from the prior year period in 2005 as a result of decreased legal and accounting costs for non cash compensation of $798,000 and lower accounting fees in 2006 from the prior year.

During the six months ended June 30, 2006, we incurred $215,262 in exploration expenses, primarily on our DJ Basin properties, relating to delay rentals.

Depreciation and depletion expense increased from $9,850 for the six months ended June 30, 2005 to $425,939 in the same period in 2006 due to the gas production in 2006 compared to none in 2005.

Other income in 2006 includes interest income from the cash balances maintained.

Anticipated and Completed Key Third Quarter Items

We plan to consider and pursue additional acquisitions as appropriate based on our business plan. As a result, we may incur due diligence and legal expenses, which will be capitalized only if we successfully complete an acquisition. If an acquisition is not successful, we will include those costs, in our general and administrative expenses in the year in which such expenses are incurred.

On August 1, 2006, we closed on a public offering of our 2.3 million shares of common stock, which raised, net of cost and expenses associated with that underwriting approximately $11.04 million.

On July 6, 2006, we announced that our directors had appointed Robert F. Bailey as a director of the Company.

Liquidity and Capital Resources

We had cash and cash equivalents of $5,140,044 at June 30, 2006, and a working capital deficit of $2,138,784.

We have revised our 2006 capital commitment to approximately $17.8 million net to the Company s interest. This revised commitment includes our proportionate costs associated with the drilling of up to 30 total wells (depending on rig availability and other factors) and our proportionate costs relative to the construction of an access road on the Piceance Basin acreage of approximately $15.75 million net to the Company s interest. We also anticipate that we could incur potential additional expenditures relating to gathering systems on our DJ Basin acreage of $500,000 (net to the Company s interest), as drilling results become known. Also included in the total $17.8 million is $1.55 million net to the Company s interest for capital requirements in respect of our commitment in the development of our Williston Basin property acquisition for the balance of the year.

We anticipate that we will utilize working capital generated from our ongoing operations in the Piceance Basin to meet some of our 2006 commitments. In addition, in March 2006, we filed S-3 and S-4 shelf registration statements for $50 million each in financing capacity, or a total of $100 million, which registration statements have been declared effective by the SEC. We may also receive proceeds from the exercise of outstanding warrants as we did during the six months ended June 30, 2006. At August 1, 2006, warrants to purchase 867,819 shares of common stock were outstanding. These warrants

have a weighted average exercise price of $3.14 per share and expire between April 2008 and December 2012.

In June 2006, we established a $50 million revolving credit facility with BNP Paribas (the Credit Facility). The Credit Facility has an initial borrowing base of $3 million and matures on June 15, 2010. The Credit Facility provides for as much as $50 million in borrowing capacity, depending upon a number of factors, such as the projected value of our proven oil and gas assets. The borrowing base for the Credit Facility at any time will be the loan value assigned to the proved reserves attributable to our and/or our subsidiaries direct or indirect oil and gas interests. The borrowing base will be redetermined on a semi-annual basis, based upon an engineering report delivered by us from an approved petroleum engineer. The Credit Facility is available for working capital requirements, capital expenditures, acquisitions, general corporate purposes and to support letters of credit.

Subsequent to June 30, 2006, we closed on a public underwriting, which raised approximately $11.04 million from the issuance of 2.3 million shares of common stock for the Company net of underwriting discounts and expenses associated with the underwriting.

There are no assurances that we will be successful in raising capital from either the debt or equity markets in the future.

Sources and Uses of Funds

Historically, our primary source of liquidity has been cash provided by equity offerings. These offerings may continue to play an important role in financing our business. Our primary uses for cash raised from third parties or generated through operations will be in respect of additional acquisitions or in connection with drilling programs associated with our various properties.

Cash Flows and Capital Expenditures

During the six months ended June 30, 2006, we used $1,401,648 of cash in our operating activities. This amount compares to $1,566,712 of cash used in our operating activities during the six month period in 2005. The decrease of net cash used in our operating activities of $165,064 was primarily due to an increase in accounts payable and accrued liabilities.

During six months ended June 30, 2006 we received cash of $2,700,000 in connection with the entering into the Acreage Earning Agreement with Noble involving our DJ Basin acreage. During the same period, we incurred costs of $7,037,981 related to our drilling and completion operations in the Piceance Basin and our acquisition of the 25% working interest in the Williston Basin.

During six months ended June 30, 2006, holders of 629,935 warrants exercised these warrants and purchased an equivalent number of common shares of the Company for net proceeds to us of $2,869,022, and holders of 350,900 stock options exercised these options and purchased an equivalent under of common shares of the Company for net proceeds to us of $1,239,732. For the six months ended June 30, 2006, we raised $4,108,756 from the combined sale of options and warrants.

Income Taxes, Net Operating Losses and Tax Credits

Since our inception, we have generated a net operating loss (NOL) carryforward for U.S. income tax purposes. Such NOL is subject to U.S. Internal Revenue Code Section 382 limitations. For losses incurred prior to 2004, utilization of the NOL is limited to approximately $900,000 per annum.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Our significant accounting policies are described in the Notes to our consolidated financial statements. In response to SEC Release No. 33-8040, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, we have identified certain of these policies as being of particular importance to the portrayal of our financial position and results of operations and which require the application of significant judgment by management. We analyze our estimates, including those related to oil and gas reserves, bad debts, oil and gas properties, marketable securities, income taxes, derivatives, contingencies and litigation, and base our estimates on historical experience and various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Reserve Estimates

Estimates of oil and gas reserves, by necessity, are projections based on geologic and engineering data, and there are uncertainties inherent in the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is a subjective process of estimating underground accumulations of oil and gas that are difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretations and judgment. Estimates of economically recoverable oil and gas reserves and future net cash flows necessarily depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effects of regulations by governmental agencies and assumptions governing future oil and gas prices, future operating costs, severance taxes, development costs and workover gas costs, all of which may vary considerably from actual results. The future drilling costs associated with reserves assigned to proved undeveloped locations may ultimately increase to the extent that these reserves may be later determined to be uneconomic. For these reasons, estimates of the economically recoverable quantities of oil and gas attributable to any particular group of properties, classifications of such reserves based on risk of recovery, and estimates of the future net cash flows expected there from may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of our oil and gas properties and/or the rate of depletion of the oil and gas properties. Actual production, revenues, and expenditures with respect to our reserves will likely vary from estimates, and such variances may be material.

Impairment of Oil and Gas Properties

We review our oil and gas properties for impairment whenever events and circumstances indicate a decline in their carrying value. We estimate the expected future cash flows of our developed proved properties and compare such future cash flows to the carrying values of the proved properties to determine if the carrying value is recoverable. If the carrying value exceeds the estimated undiscounted future cash flows, we will adjust the carrying value of the oil and gas properties to their fair value. The factors used to determine fair value include, without limitation, estimates of proved reserves, future commodity pricing, future production estimates, anticipated capital expenditures, and a discount rate commensurate with the risk associated with realizing the expected cash flows projected.

Given the complexities associated with oil and gas reserve estimates and the history of price volatility in the oil and gas markets, events may arise that would require us to record an impairment of the carrying values associated with oil and gas properties.

Stock Compensation

Effective January 1, 2006, we adopted the provisions of SFAS 123R to account for stock based compensation. Previously, we accounted for this compensation under the provisions of APB 25. Under APB 25, stock options did not result in any charge to earnings if the exercise price on the date of grant equaled or exceeded fair value (market price) on the grant date. Stock grants were charged to earnings on the vesting date based upon the market price of the stock on the date of the grant.

Under SFAS 123R, accounting for stock grants has not changed materially. We now accrue for anticipated vesting of stock grants in interim reporting periods based upon our best estimates at the time of the interim period of the conditions and criteria under which the options will vest. These conditions and criteria include service through the vesting date, announced future terminations, performance criteria based upon most recent forecasts and market conditions where appropriate. The estimates used are subjective and based upon managements judgment and may change over time as experience emerges. Changes to the interim accruals due to changes in the estimates of the conditions and criteria are recorded in the period in which the estimate changes occur.

During the quarter ended June 30, 2006, we recorded current compensation of $706,989 based on our management s current assessments of the progress being made in the satisfaction of performance and service conditions for these awards that could vest at yearend 2006, provided the milestones are achieved. The performance assessment is scored based on an evaluation of the degree of progress made in achieving each of threshold, base, and stretch objectives established by the Compensation Committee of our Board of Directors by yearend. Our compensation expense will increase or decrease in subsequent quarters based on management s progress toward the achievement of these objectives. Improved performance during the subsequent quarters of the year will increase compensation expense in those quarters whereas diminished performance will reduce compensation expense in subsequent quarters.

Under SFAS 123R, our accounting for stock options has changed materially. We now amortize the unvested portion of stock option grants over the vesting period at the fair value of the option, as described in Note 5 to the financial statements. At June 30, 2006, there were 45,000 option grants unvested.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risks. The term market risk refers to the risk of loss arising from adverse changes in natural gas and oil prices and interest rates. The disclosures are not meant to be precise indicators of expected future losses, but rather indicators of reasonably possible losses depending on market dynamics. This forward-looking information provides indicators of how we view and manage (or anticipate managing) our ongoing market risk exposures.

Commodity Price Risk

Our major market risk exposure is in the pricing applicable to our natural gas and oil production. Realized pricing is primarily driven by the prevailing worldwide price for crude oil and spot market prices applicable to our U.S. natural gas production. Pricing for natural gas and oil production has been volatile and unpredictable in past years, and we expect this volatility to continue in the future. The prices we receive for production depend on many factors outside of our control. For the three months ended June 30, 2006, our income before income taxes, including hedge settlements, would have changed by $13,134 for each $0.10 per mcf change in natural gas prices. During the three months ended June 30, 2006, we had no oil production.

To date, we have not entered into financial hedging activities with respect to any portion of our projected natural gas and oil production, although we may do so in the future, particularly if we were to make a large acquisition of producing assets.

Interest Rate Risk

At June 30, 2006, we had no debt outstanding on our Credit Facility. Under the Credit Facility, each loan bears interest at a Eurodollar rate or a base rate, as requested by us, plus an additional margin based on the amount of our total outstanding borrowings relative to the total borrowing base. The Eurodollar rate is based on the London Interbank Offered Rate (LIBOR). The base rate is the higher of the Prime Rate or the Federal Funds Rate plus one-half of one percent. In addition, under the terms of the Credit Facility, we are required to pay a commitment fee based on the average daily amount of the unused amount of the commitment of each lender. This fee accrues at a rate of 0.050% per annum and is paid quarterly in arrears on the last day of March, June, September, and December of each year and on the date on which the Credit Facility is terminated. Although there are currently no outstanding borrowings against the Credit Facility, a one hundred basis point (1.0%) increase in each of the average LIBOR rate and federal funds rate would have resulted in an estimated $7,500 increase in interest expense on a quarterly basis, assuming we were to draw down on the entire amount of our borrowing base of $3 million.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as of the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Based on that evaluation, our Chief Executive Offer and Chief Financial Officer concluded that, as of the end of such period, our disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting during the six months ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

Our Annual Meeting of Shareholders was held on April 13, 2006. The matters voted upon, including the number or votes cast for, against or withheld, as well as the number of abstentions, as to each such matter were as follows:

Proposal 1: All five nominees for directors listed in the Company s 2006 proxy statement were elected. The number of votes cast for each nominee was as follows:

Karl F. Arleth	7,976,004	Shares In Favor	127,820	Shares Withheld
John T. Connor, Jr.	7,975,999	Shares In Favor	127,825	Shares Withheld
Thomas F. Conroy	7,971,601	Shares In Favor	132,223	Shares Withheld
William K. White	7,838,561	Shares In Favor	265,263	Shares Withheld
James J. Woodcock	7,788,966	Shares In Favor	314,828	Shares Withheld

Proposal 2: The Proposal to appoint Ehrhardt Keefe Steiner & Hottman PC as independent auditors to examine the Company s financial statements for the fiscal year ending December 31, 2006 was ratified by the following vote:

For	Against	Abstain
8,088,813	12,611	2,400

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS:

Exhibits

10.1 Purchase Agreement between American Oil and Gas, Inc. and Teton Energy Corporation.

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

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

32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

TETON ENERGY CORPORATION

Date: August 14, 2006	By:	/s/ Karl F. Arleth Karl F. Arleth President and Chief Executive Officer
Date: August 14, 2006	By:	/s/ Bill I. Pennington Bill I. Pennington Chief Financial Officer (Principal Financial and Accounting Officer)
