

Financial Highlights

(in thousands, except per share data)

Years ended December 31, 1999 1998

Consolidated Statements of Operations:

Revenues:		
Sales	\$ 60,052	\$ 60,684
Grants and royalties	792	368
Total revenues	60,844	61,052
Operating expenses:		
Cost of sales	11,239	9,555
Research and development	30,397	28,993
Selling, general and administrative	29,165	20,074
License fee	—	4,000
Total operating expenses	70,801	62,622
Operating loss	(9,957)	(1,570)
Net other income	1,762	3,453
Net income (loss)	\$ (8,195)	\$ 1,883
Income (loss) per common share:		
Basic	\$ (0.50)	\$ 0.12
Diluted	\$ (0.50)	\$ 0.11
Weighted average common shares outstanding:		
Basic	16,406,734	16,265,452
Diluted	16,406,734	17,155,691

At December 31, 1999 1998

Consolidated Balance Sheets:

Cash, cash equivalents and investment securities	\$ 45,006	\$ 55,007
Total current assets	68,211	79,784
Total assets	100,837	112,766
Total current liabilities	14,422	14,631
Long-term liability	—	4,725
Total stockholders' equity	86,414	93,410

Selected Ratios:

Cost of sales/sales	18.7%	15.8%
Research and development/revenues	50.0%	47.5%
Selling, general and administrative expenses/revenues	47.9%	32.9%

Selected Financial Data

(In thousands, except per share data)

Years ended December 31,	1999	1998	1997	1996	1995
Statement of Operations Data:					
Revenues:					
Sales	\$60,052	\$60,684	\$ —	\$ —	\$ —
Grants and royalties	792	368	442	440	—
Total revenues	60,844	61,052	442	440	—
Operating expenses:					
Cost of sales	11,239	9,555	—	—	—
Research and development	30,397	28,993	28,018	20,673	15,668
Selling, general and administrative	29,165	20,074	10,582	4,241	3,609
License fee	—	4,000	—	—	—
Total operating expenses	70,801	62,622	38,600	24,914	19,277
Operating loss	(9,957)	(1,570)	(38,158)	(24,474)	(19,277)
Other income (expense):					
Investment income, net	2,707	4,056	5,278	3,294	1,287
Interest expense	(627)	(493)	—	—	—
Other expense	(318)	(110)	(158)	(84)	(34)
Net other income	1,762	3,453	5,120	3,210	1,253
Net income (loss)	\$ (8,195)	\$ 1,883	\$(33,038)	\$(21,264)	\$(18,024)
Income (loss) per common share:					
Basic	\$ (0.50)	\$ 0.12	\$ (2.10)	\$ (1.66)	\$ (2.20)
Diluted	\$ (0.50)	\$ 0.11	\$ (2.10)	\$ (1.66)	\$ (2.20)
Weighted average common shares outstanding:					
Basic	16,407	16,265	15,704	12,829	8,210
Diluted	16,407	17,156	15,704	12,829	8,210

In thousands

At December 31,	1999	1998	1997	1996	1995
Balance Sheet Data:					
Cash, cash equivalents and investment securities					
	\$ 45,006	\$ 55,007	\$79,041	\$60,688	\$37,447
Total current assets	68,211	79,784	87,190	61,809	38,884
Total assets	100,837	112,766	97,596	69,999	46,963
Total current liabilities	14,422	14,631	8,107	2,974	3,453
Long-term liability	—	4,725	—	98	462
Total stockholders' equity	86,414	93,410	89,489	66,926	43,048

Management's Discussion and Analysis of Financial Condition and Results of Operations

In reading the discussion below, you should keep in mind that it contains forward-looking statements involving risks and uncertainties that affect our future operating results. Those factors include, but are not limited to, uncertainties related to the fact that PathoGenesis only began commercial operations in 1998, its dependence on TOBI, the degree of penetration of its markets and frequency of TOBI's use by patients, risks associated with marketing TOBI in international markets, third party reimbursement and product pricing, seasonal impacts on hospitalizations or exacerbations experienced by patients, variability in wholesaler ordering patterns, drug development and clinical trials, uncertain outcome of the U.S. and international drug approval process, competition and alternative therapies. A discussion of some of those factors is included in Exhibit 99.1 of our annual report on Form 10-K for 1999.

Results of Operations

Years Ended December 31, 1999 and 1998

Revenues

Revenues in 1999 totaled \$60.8 million, including \$60.1 million from TOBI sales. Research grants and royalties generated the balance of \$792,000. Revenues for 1998 were \$61.1 million, including \$60.7 million from TOBI sales in the first year of the drug's launch. Research grants and royalties generated the balance of \$368,000 in 1998. Because we launched TOBI in 1998, sales in that year benefited from initial purchases of stock to fill the distribution chain. In addition, our 1999 and 1998 sales were affected by quarterly fluctuations in ordering patterns for TOBI. Quarterly TOBI sales volume is influenced by a number of factors, including underlying demand and wholesaler inventory management practices.

Operating Expenses

We incurred total operating expenses of \$70.8 million in 1999, an increase of \$8.2 million from \$62.6 million in 1997. Cost of sales was \$11.2 million in 1999, an increase of \$1.7 million from \$9.6 million in 1998. This increase in the cost of sales is the result of a reduction in the number of manufacturing batches in 1999, leading to a higher portion of manufacturing costs being charged directly to cost of sales. Research and development expense for 1999 increased by \$1.4 million to \$30.4 million from \$29.0 million in 1998. Selling, general and administrative expenses increased to \$29.2 million in 1999 from \$20.1 million in 1998 due mainly to increased sales and marketing costs. In 1999, we increased our U.S. sales force 30%. We also expanded our advisory board of respected cystic fibrosis physicians,

who are assisting us in communicating the extensive data now available on TOBI. We also made significant strides in expanding the international market for TOBI. In 1999 and early 2000, we received regulatory approvals to market TOBI in Canada, Argentina, Israel, Australia and the United Kingdom. General and administrative expenses also rose due to staff-related and consulting costs.

Net Income (Loss)

We had an operating loss of \$10.0 million in 1999, an increase of \$8.4 million from the operating loss of \$1.6 million in 1998. This increased loss was due to higher operating expenses in 1999, primarily relating to sales and marketing costs. Including net other income (primarily income from investment securities), our net loss for 1999 was \$8.2 million, compared to net income of \$1.9 million in 1998. In 1999, net investment income decreased by \$1.4 million to \$2.7 million from \$4.1 million in 1998. The decrease was primarily due to lower average invested cash balances. Interest expense, most of which represents the amortization of the discount on the remaining installments of our obligation to the Cystic Fibrosis Foundation, totaled \$627,000 and \$493,000 in 1999 and 1998, respectively.

Years Ended December 31, 1998 and 1997

Revenues

Revenues in 1998 totaled \$61.1 million, including \$60.7 million from TOBI sales in the first year of the drug's launch. Research grants and royalties generated the balance of \$368,000. Revenues for 1997 were \$442,000, which were entirely generated by research grants and royalties.

Operating Expenses

We incurred total operating expenses of \$62.6 million in 1998, an increase of \$24.0 million from \$38.6 million in 1997. The costs of manufacturing and marketing TOBI accounted for the majority of the increase. A \$4.0 million license fee to Bristol-Myers Squibb for PA-1806, a novel, patented drug candidate being developed as an inhaled antibiotic, also represented a significant portion of the increase. Cost of sales was \$9.6 million in 1998. We did not incur such costs in 1997 because sales did not begin until 1998. Our research and development expense for 1998 increased by \$1.0 million to \$29.0 million from \$28.0 million in 1997. These costs rose as we continued to develop new drug candidates and pursue regulatory approval of TOBI in Canada, Europe and other markets. Selling, general and administrative expenses increased to \$20.1 million in 1998 from \$10.6 million in 1997. The increase primarily reflects the costs associated with supporting our U.S. sales and marketing effort, adding administrative staff and developing a sales and marketing program in Europe.

Net Income (Loss)

We had an operating loss of \$1.6 million in 1998, a decrease of \$36.6 million from the operating loss of \$38.2 million in 1997. This decline in operating loss was due to TOBI sales revenues in 1998. Including net other income (primarily income from investment securities), our net income for 1998 was \$1.9 million, compared to a net loss of \$33.0 million in 1997. In 1998, net investment income decreased by \$1.2 million to \$4.1 million from \$5.3 million in 1997. The decrease was primarily due to lower average invested cash balances. Interest expense in 1998 totaled \$493,000. We had no interest expense in 1997.

Liquidity and Capital Resources

Our combined cash, cash equivalents and investment securities totaled \$45.0 million at December 31, 1999, a decrease of \$10.0 million from the balance of \$55.0 million at December 31, 1998. We expect that these funds, in combination with expected revenues from sales of TOBI, should be sufficient to meet our operating expenses and capital requirements for the foreseeable future. In addition, we obtained a \$10.0 million revolving line of credit in 1999 from Harris Trust and Savings Bank.

Net cash used in operating activities totaled \$1.2 million for 1999, compared to \$9.6 million in 1998. We incurred an \$8.2 million net loss for 1999, compared to net income of \$1.9 million for 1998. Significant changes in working capital components included a \$4.9 million decrease in accounts receivable and \$4.7 million increase in inventory, compared to increases of \$11.0 million and \$5.0 million, respectively, in 1998. Also, license payable decreased by \$2.0 million in 1999 as we paid the second half of our initial obligation to Bristol-Myers Squibb. In addition, during 1999 we purchased \$4.4 million in property and equipment and made our second installment payment of \$5.3 million for the rights in TOBI acquired from the Cystic Fibrosis Foundation. At December 31, 1999, our working capital was \$53.8 million and current ratio was 4.73 to 1.

In 2000, we expect net cash flow from operations to be about break-even. We expect to incur capital expenditures of approximately \$4.0 million to \$6.0 million. In March 2000, we invested \$2.5 million in convertible preferred stock of privately held AeroGen, Inc. In addition, the final installment payment of \$5.3 million to the Cystic Fibrosis Foundation will be due in May 2000. This cash flow projection does not include the effects of any licensing or collaboration agreements which we may enter into in 2000.

We plan to continue our policy of investing excess funds in government securities and investment grade, interest-bearing securities, primarily those with an expected maturity of one-and-one-half years or less. We do not invest in derivative financial instruments, as defined by Statement of Financial Accounting Standards (SFAS) No. 119, *Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments*.

At December 31, 1999, we had tax net operating loss carryforwards of approximately \$100.6 million and research and experimentation tax credit carryforwards of approximately \$1.5 million, both of which will begin to expire in 2007. We also have orphan drug credits of approximately \$5.0 million, which will expire beginning in 2007.

Outlook

We expect sales of TOBI to increase in 2000, as we further penetrate the U.S. cystic fibrosis market, gain approvals for TOBI in international markets and expand TOBI's use in other patients with serious lung infections. We expect cost of sales as a percentage of sales to decline slightly in 2000 as sales volumes increase. We expect our sales and marketing costs to continue increasing at a rate comparable to prior years as we expand U.S. sales and open new markets in Europe and elsewhere. Having received marketing approval for TOBI in the U.K., we are seeking approval for TOBI from the other European Union countries through a mutual recognition process. We are marketing TOBI using our own sales force in the U.K. and Canada. We intend to market TOBI ourselves in several other countries, while working through distributors elsewhere. To date, we have secured agreements with specialized local distributors in Argentina, Australia, Cyprus, Germany, Greece, Israel, Italy and the Nordic countries.

Research and development costs are expected to increase in 2000 as we invest in a number of new development initiatives. For example, we intend to conduct or co-sponsor a number of Phase IV clinical trials of TOBI in cystic fibrosis, bronchiectasis, ventilator-associated pneumonia and lung transplant patients. In addition, we currently plan to begin Phase I clinical trials of PA-1806 later in 2000.

We have begun a program to develop a more convenient version of TOBI. Our goal is to reduce TOBI's delivery time from 15-20 minutes to 5-10 minutes or less. Drug delivery companies are developing new generations of nebulizers and dry powder delivery devices that were not available when TOBI was formulated in 1994. These devices are hand-held, portable and do not require the use of an electrically powered air compressor. In March 2000, we entered into an agreement with AeroGen, Inc. to collaborate on the development and registration of a product combining TOBI and AeroGen's hand-held, portable AeroDose™ Inhaler. Under the development and supply agreement, we will reimburse AeroGen for costs incurred in developing the AeroDose Inhaler and will obtain worldwide exclusive distribution rights to the product. AeroGen will receive royalties on all product sales.

We also intend to select and initiate development of at least one other antibiotic for inhalation to address broader respiratory infection markets, as a result of our own research programs and collaborations with others. In January 2000, we announced a research collaboration with Chiron Corp., with the goal of identifying new classes of antibiotics for oral, intravenous and inhaled administration that could address the increasingly important issue of drug resistance. The collaboration seeks to combine Chiron's strong combinatorial chemistry library and expertise in high-throughput screening with our strengths in bacterial target discovery and antibiotic development, as well as our knowledge of the *P. aeruginosa* genome (genetic structure).

Year 2000

We completed our year 2000 compliance program in late 1999, which included verification testing of our internal information technology and information systems. In addition, we contacted key third parties, such as suppliers, customers and financial institutions, to assure no interruption of our business relationships would occur due to year 2000 compliance issues. Our existing systems that were not year 2000-compliant represented a small percentage of our systems, and almost all noncompliant systems were replaced as part of normal technology upgrades in 1999. The remaining systems were evaluated on an individual basis, and upgraded or replaced as necessary. Our total year 2000 compliance costs were approximately \$50,000 in 1999, excluding the costs of technology upgrades made in the ordinary course of business.

Our systems successfully transitioned to the year 2000, and to date we have not experienced any significant problems associated with year 2000 issues. However, there may be latent problems that surface at certain dates or events in the future. We will continue to monitor our systems and those of key third parties throughout the year 2000 to ensure that any latent problems are addressed promptly.

Consolidated Balance Sheets

December 31,	1999	1998
Assets		
Current assets:		
Cash and cash equivalents	\$ 10,456,031	\$ 8,139,153
Investment securities	34,549,738	46,868,390
Accounts receivable, net	6,038,299	10,961,242
Interest receivable	442,676	427,618
Inventories	14,613,385	9,907,916
Other current assets	2,110,610	3,480,022
Total current assets	68,210,739	79,784,341
Restricted investment	—	675,000
Property and equipment, at cost:		
Land	3,030,938	3,194,923
Building and improvements	1,454,850	1,515,543
Leasehold improvements	9,735,242	9,367,898
Furniture and equipment	16,948,235	13,263,162
	31,169,265	27,341,526
Less accumulated depreciation and amortization	12,957,926	9,704,385
Net property and equipment	18,211,339	17,637,141
License rights, net	13,591,321	14,562,129
Other assets	823,519	107,136
	\$100,836,918	\$112,765,747
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 1,668,775	\$ 1,180,909
Compensation and benefits	2,524,184	2,580,790
Clinical development costs	1,391,383	199,869
Accrued royalties	906,629	827,739
License payable	—	2,000,000
Other accrued expenses	2,781,644	2,691,572
Current portion of long-term liability	5,149,847	5,149,847
Total current liabilities	14,422,462	14,630,726
Long-term liability, net of current portion	—	4,724,630
Commitments and subsequent events		
Stockholders' equity:		
Preferred stock, \$0.01 par value. Authorized 1,000,000 shares; none issued and outstanding	—	—
Common stock, \$0.001 par value. Authorized 60,000,000 shares; 16,451,530 shares and 16,328,580 shares issued and outstanding at December 31, 1999 and 1998, respectively	16,452	16,329
Additional paid-in capital	194,641,919	193,188,363
Deferred compensation	(526,199)	(987,156)
Accumulated other comprehensive income (loss)	(582,036)	133,117
Accumulated deficit	(107,135,680)	(98,940,262)
Total stockholders' equity	86,414,456	93,410,391
	\$100,836,918	\$112,765,747

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

Years ended December 31,	1999	1998	1997
Revenues:			
Sales	\$60,052,486	\$60,684,091	\$ —
Grants and royalties	791,739	367,673	441,880
Total revenues	60,844,225	61,051,764	441,880
Operating expenses:			
Cost of sales	11,239,170	9,555,213	—
Research and development	30,397,456	28,992,714	28,017,738
Selling, general and administrative	29,164,673	20,073,736	10,582,072
License fee	—	4,000,000	—
Total operating expenses	70,801,299	62,621,663	38,599,810
Operating loss	(9,957,074)	(1,569,899)	(38,157,930)
Other income (expense):			
Investment income, net	2,706,739	4,055,821	5,278,098
Interest expense	(626,727)	(492,551)	—
Other expense	(318,356)	(110,470)	(157,898)
Net other income	1,761,656	3,452,800	5,120,200
Net income (loss)	\$ (8,195,418)	\$ 1,882,901	\$(33,037,730)
Income (loss) per common share:			
Basic	\$ (0.50)	\$ 0.12	\$ (2.10)
Diluted	\$ (0.50)	\$ 0.11	\$ (2.10)
Weighted average common shares outstanding:			
Basic	16,406,734	16,265,452	15,704,151
Diluted	16,406,734	17,155,691	15,704,151

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

Business

PathoGenesis Corporation is a pharmaceutical company that develops and commercializes drugs to treat chronic infectious diseases where there is a significant need for improved therapy. We market TOBI[®] (tobramycin solution for inhalation), an inhaled antibiotic, for management of *P. aeruginosa* lung infections in patients with cystic fibrosis. In addition, PathoGenesis is developing other drug candidates to treat serious chronic lung infections, including those common in cystic fibrosis, bronchiectasis and ventilator patients.

Concentrations of Risk

Substantially all our revenue is currently generated through sales of TOBI. Our other drug candidates are not expected to be commercially available for at least several years, if at all. Therefore, a significant change in demand or pricing for TOBI, or the introduction of a competing product, are among the factors that could have a material impact on our operations.

PathoGenesis uses wholesale distributors of pharmaceutical products as the principal means of distributing TOBI to clinics, hospitals and pharmacies. For 1999 and 1998, sales to our three largest wholesale distributors were 64% and 65% of total sales, respectively. Accounts receivable from these distributors were 44% and 63% of total accounts receivable at December 31, 1999 and 1998, respectively.

We purchase our primary basic raw material, bulk powdered tobramycin, from two of the principal worldwide suppliers of the drug. We anticipate that either one of these suppliers alone will be able to supply sufficient quantities to meet current needs. However, there can be no assurance that these suppliers will be able to meet future demand in a timely and cost-effective manner. Our operations could be adversely affected by an interruption or reduction in the supply of raw material.

PathoGenesis has entered into contracts with third parties for the production and packaging of TOBI. Our reliance on external sources of production and packaging can be shifted, over time, to alternative sources should such changes be necessary. However, if the contract manufacturers become unable to produce or package sufficient quantities of TOBI due to work stoppages or other factors beyond our control, our operations could be disrupted until alternative sources are secured.

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the company and its wholly owned subsidiaries, PathoGenesis Limited and PathoGenesis Canada Limited. All significant intercompany accounts and transactions have been eliminated in consolidation.

Cash Equivalents

All investments in debt instruments with a contractual maturity of three months or less at the date of purchase are considered to be cash equivalents. Cash equivalents totaled \$1,900,000 at December 31, 1999. There were no cash equivalents at December 31, 1998.

Investment Securities

Our investment securities are classified as available-for-sale and carried at market value, with unrealized gains and losses excluded from the consolidated statements of operations and reported in other comprehensive income (loss). Realized gains and losses on the sales of investment securities are determined on the specific identification method and included in investment income, net.

Investment in Affiliate

In 1999, we acquired approximately 20% of the issued share capital of PulmoPharm GmbH, a distributor of pharmaceutical products in Germany. This investment is included in other assets and is accounted for using the equity method. Accordingly, the investment is recorded at cost, adjusted for our share of income or losses of the entity.

Inventories

Inventories are stated at the lower of cost, as determined by the first-in, first-out method, or market.

Depreciation and Amortization

Improvements, furniture and equipment are depreciated using the straight-line method over the assets' estimated useful lives of 5 to 10 years. Leasehold improvements are amortized using the straight-line method over the shorter of the assets' estimated useful lives or the remaining term of the lease. Our building in England is depreciated using the straight-line method over its estimated useful life of 40 years.

Revenues

Product sales are recognized upon shipment. We perform ongoing credit evaluations of our customers and generally do not require collateral. Product sales are recorded net of reserves for estimated chargebacks, returns, discounts and rebates. Allowances for discounts, returns, bad debts, chargebacks and rebates, which are netted against accounts receivable, totaled \$3,187,373 and \$1,550,864 at December 31, 1999 and 1998, respectively.

In December 1999, the Securities and Exchange Commission released Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, which must be applied in the first quarter of 2000. SAB No. 101 provides guidance on revenue recognition issues. We do not expect the adoption of SAB No. 101 to have a current impact on our financial statements.

Translation of Foreign Currencies

The financial statements of our subsidiaries are translated from local currency into U.S. dollars using the current

exchange rate at the balance sheet date for assets and liabilities, and the average exchange rate prevailing during the period for revenues and expenses. The local currency is considered to be the functional currency for each entity and accordingly, translation adjustments for these subsidiaries are included as a component of accumulated other comprehensive income or loss in stockholders' equity. Transaction gains and losses are recorded in other income (expense) and were insignificant in 1999 and 1998.

Research and Development Costs

Research and development costs are charged to expense as incurred.

Income Taxes

Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and for net operating loss and tax credit carryforwards.

Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. 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. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

Fair Value of Financial Instruments

Our financial instruments other than investments consist of cash and cash equivalents, accounts receivable, interest receivable, accounts payable and a contract payable. The fair value of these financial instruments approximates their carrying amount due to their short-term nature or current market indicators.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other gains and losses affecting stockholders' equity that, under generally accepted accounting principles, are excluded from net income (loss). These include unrealized gains or losses on available-for-sale securities and foreign currency translation adjustments. Unrealized gain (loss) on investment securities included in comprehensive income (loss) for 1999 and 1998 is net of the reclassification adjustment for losses included in net income (loss) of approximately \$72,000 and \$24,700, respectively.

Business Segments

In 1998, we adopted SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. SFAS No. 131 requires an enterprise to report segment information based on how management internally evaluates the operating performance of its business units (segments). Our operations are confined to one business segment, the development of drugs to treat chronic infectious diseases.

Stock-Based Compensation

We account for stock option plans for employees in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. As such, compensation expense related to employee stock options is recorded if, on the date of grant, the fair value of the underlying stock exceeds the exercise price. We apply the disclosure-only requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, which allows entities to continue to apply the provisions of APB Opinion No. 25 for transactions with employees, and to provide pro forma results of operations disclosures for employee stock option grants made in 1995 and subsequent years as if the fair-value-based method of accounting in SFAS No. 123 had been applied to those transactions.

Income (Loss) Per Share

Basic income (loss) per share is computed on the basis of the weighted average number of shares of common stock outstanding for the year. Diluted income (loss) per share is computed on the basis of the weighted average number of shares of common stock plus dilutive potential shares outstanding using the treasury stock method. Potential dilutive shares of common stock consist of shares issuable to holders of unexercised employee stock options and warrants outstanding.

Use of Estimates

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

Impairment of Long-Lived Assets

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of their carrying amount or fair value less costs to sell.

2. Investment Securities

The following summarizes our investment securities at December 31:

	Amortized cost	Gross unrealized gains	Gross unrealized gains	Market value
1999:				
U.S. Treasury notes	\$ 913,453	\$ —	\$ (10,078)	\$ 903,375
Federal mortgage notes	2,874,782	816	(31,197)	2,844,401
Corporate obligations	31,056,356	9,343	(263,737)	30,801,962
	\$34,844,591	\$ 10,159	\$(305,012)	\$34,549,738
1998:				
Federal mortgage notes	\$ 2,629,558	\$ 12,350	\$ (4,034)	\$ 2,637,874
Municipal bonds	452,362	52	—	452,414
Corporate obligations	43,653,353	182,268	(57,519)	43,778,102
	\$ 46,735,273	\$194,670	\$ (61,553)	\$ 46,868,390

Amortized cost and market value of investment securities at December 31, 1999, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Maturities	Amortized cost	Market value
Due in 1 year or less	\$ 9,810,325	\$ 9,748,786
Due between 1 year to 5 years	19,045,123	18,857,186
Due between 5 years to 10 years	1,818,355	1,809,653
Due after 10 years	4,170,788	4,134,113
	\$34,844,591	\$34,549,738

Investment income, net includes interest of \$2,849,838, \$4,098,440, and \$5,216,693 earned on investments and gains (losses) of \$(143,099), \$(42,619) and \$61,405 realized upon the sale of investments for 1999, 1998 and 1997, respectively.

3. Inventories

Inventories consisted of the following at December 31:

	1999	1998
Finished goods	\$ 2,433,718	\$4,174,206
Work in progress	2,907,128	2,747,380
Raw materials and supplies	9,272,539	2,986,330
	\$14,613,385	\$9,907,916

4. License Agreement

Effective September 30, 1998, we entered into a license agreement with Bristol-Myers Squibb to obtain exclusive worldwide rights to PA-1806, a patented chemical compound in the monobactam class of antibiotics. PathoGenesis obtained the rights to PA-1806 for inhaled, non-systemic administration of the compound for the treatment or prophylaxis of respiratory tract infectious diseases. The initial payment obligation for this license of \$4.0 million was

charged to expense as license fee in 1998. Payment of \$2.0 million was made in October 1998, with the \$2.0 million balance paid in January 1999. Subsequent payments totaling \$4.0 million could be made upon accomplishment of certain milestones. We will pay a royalty on net sales of products using the chemical compound.

5. Acquisition of License Rights

In 1994, we entered into license agreements with the Cystic Fibrosis Foundation and another party to obtain worldwide rights to TOBI. Pursuant to our license agreement with the foundation, we were required to make royalty payments of 2.5% on net product sales through the patent expiration date of TOBI. In 1998, we acquired the foundation's rights in TOBI for payments totaling \$16.0 million, to be made in three equal annual installments.

The purchase amount has been recorded on our consolidated balance sheet at the net present value of the required cash payments, using a discount rate of 9%. The value of the license rights is being amortized to cost of sales over the remaining life of the TOBI patent. Accumulated amortization totaled \$1,123,939 and \$153,131 at December 31, 1999 and 1998, respectively.

A corresponding discounted liability has been recorded for the remaining installment payment obligation to the foundation. The discount is being amortized to interest expense over the installment term, using the effective interest method. The \$5,333,333 portion of the purchase price payable after December 31, 1999 is secured by an irrevocable standby letter of credit issued by a bank. This letter of credit is secured by our investment securities.

6. Stockholders' Equity

Common Stock

Effective June 25, 1997, our stockholders approved an increase in the authorized number of shares of PathoGenesis' \$0.001 par value common stock to 60,000,000 shares.

Stock Option Plans

In 1992, we adopted the 1992 Stock Option Plan, under which 1,500,000 shares of common stock were authorized to be reserved for grants. At December 31, 1999, 27,141 shares remained available for future awards. Options granted under that plan may be designated as qualified or nonqualified at the discretion of the compensation and nominating committee of the board of directors.

In 1997, we adopted the 1997 Stock Option Plan, under which 2,000,000 shares of common stock were reserved for grants. At December 31, 1999, 128,126 shares remained available for future awards. Options granted under that plan may be designated as qualified or nonqualified at the discretion of the compensation and nominating committee of the board of directors. A number of options were granted in 1997 under the plan before the plan received stockholder approval. This resulted in deferred compensation of approximately \$1,594,000, based on the excess of the fair market value of the stock at the time of plan approval (measurement date) over the exercise price, which was based on the fair value of the stock at the time of option grant. Deferred compensation of approximately \$201,000 was recognized in 1998 as a result of option grants to consultants. Deferred compensation is being amortized on the straight-line method over the vesting period of the options.

In 1999, we adopted the 1999 Employee Stock Option Plan, under which 600,000 shares of common stock were reserved for grants. At December 31, 1999, 148,100 shares remained available for future awards. Options granted under that plan are designated as nonqualified.

In 1999, we also adopted the 1999 Stock Plan, under which 800,000 shares of common stock were reserved for grants. At December 31, 1999, 290,000 shares remained available for future awards. Options granted under that plan may be designated as qualified or nonqualified at the discretion of the compensation and nominating committee of the board of directors.

In 1996, we adopted the 1996 Directors Stock Option Plan (Directors Plan) for nonemployee directors, under which 300,000 shares of common stock were reserved for grants. Upon adoption of the 1997 Stock Option Plan, the Directors Plan was terminated with no further grants to be made.

Generally, options vest over a four-year period in installments of 25% each year beginning one year from the date of grant. However, certain options can vest upon grant. Vested options may be exercised at any time before their expiration date. All options expire not later than 10 years from the date of grant. Qualified stock options are exercisable at not less than the fair market value of the stock at the date of grant. Nonqualified stock options are exercisable at prices determined at the discretion of the board of directors, but not less than 85% of the fair market value of the stock at the date of grant.

A summary of stock options follows:

	1992 Stock Plan	Directors Plan	1997 Stock Plan	1999 Employee Stock Plan	1999 Stock Plan	Weighted average exercise price
Balances at December 31, 1996	1,224,775	42,000	—	—	—	\$ 12.73
Granted	134,205	—	658,995	—	—	26.04
Canceled	(33,108)	—	(19,150)	—	—	18.52
Exercised	(169,543)	(8,000)	—	—	—	12.10
Balances at December 31, 1997	1,156,329	34,000	639,845	—	—	18.51
Granted	—	—	683,597	—	—	34.95
Canceled	(20,125)	—	(47,523)	—	—	27.23
Exercised	(74,766)	—	(15,165)	—	—	15.28
Balances at December 31, 1998	1,061,438	34,000	1,260,754	—	—	23.15
Granted	—	—	735,792	520,300	510,000	25.09
Canceled	(3,087)	—	(139,837)	(68,400)	—	29.37
Exercised	(31,044)	—	(6,638)	—	—	14.37
Balances at December 31, 1999	1,027,307	34,000	1,850,071	451,900	510,000	\$23.78

The weighted average fair value of options granted was \$13.91, \$17.76 and \$14.06 in 1999, 1998 and 1997, respectively.