NovaBay Pharmaceuticals, Inc.
Form 10-Q
November 12, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from to

Commission file number 001-33678

NOVABAY PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**68-0454536**
(State or other jurisdiction of incorporation or	**(I.R.S. Employer Identification No.)**

organization)

5980 Horton Street, Suite 550, Emeryville CA 94608

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of November 5, 2014, there were 51,625,132 shares of the registrant's common stock outstanding.

NOVABAY PHARMACEUTICALS, INC.

TABLE OF CONTENTS

Unless the context requires otherwise, all references in this report to “we,” “our,” “us,” the “Company” and “NovaBay” refer to NovaBay Pharmaceuticals, Inc. and its subsidiaries.

PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)	September 30, 2014 (unaudited)	December 31, 2013 (Note 2)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,884	$ 10,500
Short-term investments	1,251	2,553
Accounts receivable	364	784
Inventory	405	231
Prepaid expenses and other current assets	514	723
Total current assets	10,418	14,791
Property and equipment, net	478	718
Other assets	147	141
TOTAL ASSETS	$ 11,043	$ 15,650
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ 918	$ 1,674
Accrued liabilities	1,176	1,616
Deferred revenue	259	337
Total current liabilities	2,353	3,627
Deferred revenues - non-current	2,212	1,534
Deferred rent	164	136
Warrant liability	624	1,837
Total liabilities	5,353	7,134
Stockholders' equity:		
Preferred stock, $0.01 par value; 5,000 shares authorized; none outstanding at September 30, 2014 and December 31, 2013	—	—

Common stock, $0.01 par value; 120,000 shares authorized at September 30, 2014 and 65,000 shares authorized at December 31, 2013; 51,143 and 44,624 issued and outstanding at September 30, 2014 and December 31, 2013, respectively	511	446
Additional paid-in capital	72,267	64,438
Accumulated other comprehensive loss	(9)	(15)
Accumulated deficit during development stage	(67,079)	(56,353)
Total stockholders' equity	5,690	8,516
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 11,043	$ 15,650

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

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(unaudited)

(in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,		Cumulative Period from July 1, 2002 (inception) to September 30, 2014
	2014	**2013**	**2014**	**2013**	
Sales:					
Product revenue	$90	$(1)	$299	$78	$ 536
Cost of goods sold	42	43	189	82	359
Gross profit	48	(44)	110	(4)	177
Other revenue:					
License, collaboration and distribution revenue	23	1,035	99	2,739	60,598
Other revenues	39	65	165	150	478
Total other revenue	62	1,100	264	2,889	61,076
Operating expenses:					
Research and development	2,312	2,513	7,078	8,424	79,685
Sales, general and administrative	1,911	1,525	5,273	5,081	51,240
Total operating expenses	4,223	4,038	12,351	13,505	130,925
Operating loss	(4,113)	(2,982)	(11,977)	(10,620)	(69,672)
Non-cash gain (loss) on changes in fair value of warrants	(104)	(866)	1,213	(1,282)	1,365
Other income (expense), net	(2)	3	48	8	1,315
Loss before provision for income taxes	(4,219)	(3,845)	(10,716)	(11,894)	(66,992)
Provision for income taxes	—	(3)	(10)	(11)	(87)
Net loss	(4,219)	(3,848)	(10,726)	(11,905)	(67,079)
Change in unrealized gains (losses) on available-for-sale securities	3	6	6	(13)	(9)
Comprehensive loss	$(4,216)	$(3,842)	$(10,720)	$(11,918)	$ (67,088)
Net loss per share:					

Basic and diluted	$(0.08)	$(0.10)	$(0.22)	$(0.32)
Shares used in per share calculations:				
Basic and diluted	50,821	37,467	48,995	37,166

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

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Cumulative Period from July 1, 2002 (inception) to September 30, 2014
Cash flows from operating activities:			
Net loss	$(10,726)	$(11,905)	$(67,079)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	185	240	2,769
Accretion of discount on short-term investments	—	—	(252)
Net realized loss on sales of short-term investments	29	19	166
Loss (gain) on disposal of property and equipment	(54)	—	259
Stock-based compensation expense for options and stock issued to employees and directors	654	705	7,616
Compensation expense for warrants issued for services	—	166	366
Stock-based compensation expense for options, warrants and stock issued to non-employees	121	98	1,460
Non-cash loss (gain) on changes in fair value of warrants	(1,213)	1,282	(1,365)
Taxes paid by LLC	—	—	1
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	583	671	(201)
(Increase) decrease in inventory	(175)	(40)	(406)
(Increase) decrease in prepaid expenses and other assets	195	115	(471)
Increase (decrease) in accounts payable and accrued liabilities	(1,115)	959	2,517
Increase (decrease) in deferred revenue	601	(604)	2,821
Net cash used in operating activities	(10,915)	(8,294)	(51,799)
Cash flows from investing activities:			
Purchases of property and equipment	(63)	(36)	(3,565)
Proceeds from disposal of property and equipment	109	—	161
Purchases of short-term investments	(4,012)	(4,330)	(121,760)
Proceeds from maturities and sales of short-term investments	5,299	4,550	120,526
Cash acquired in purchase of LLC	—	—	516

Net cash provided by (used in) investing activities	1,333	184	(4,122)
Cash flows from financing activities:			
Proceeds from preferred stock issuances, net	—	—	11,160
Proceeds from common stock issuances	179	425	9,071
Proceeds from exercise of options and warrants	6	1,884	5,012
Proceeds from initial public offering, net of costs	—	—	17,077
Proceeds from shelf offering, net of costs	6,781	—	20,364
Proceeds from stock subscription receivable	—	—	873
Proceeds from issuance of notes	—	—	405
Principal payments on capital lease	—	—	(157)
Proceeds from short-term borrowing	—	—	88
Principal payment on short-term borrowing	—	—	(88)
Proceeds from borrowings under equipment loan	—	—	1,216
Principal payments on equipment loan	—	—	(1,216)
Net cash provided by financing activities	6,966	2,309	63,805
Net increase (decrease) in cash and cash equivalents	(2,616)	(5,801)	7,884
Cash and cash equivalents, beginning of period	10,500	12,735	—
Cash and cash equivalents, end of period	$7,884	$6,934	$7,884

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

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. ("we," "NovaBay" or the "Company") is a biopharmaceutical company focused on the development and commercialization of its non-antibiotic anti-infective products.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. We had no operations until July 1, 2002, on which date we acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, we changed our name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In August 2007, we formed two subsidiaries—NovaBay Pharmaceuticals Canada, Inc., a wholly-owned subsidiary incorporated under the laws of British Columbia (Canada), which was formed to conduct research and development in Canada which was dissolved in July 2012, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. In June 2010, we changed the state in which we are incorporated (the Reincorporation), and are now incorporated under the laws of the State of Delaware. All references to "we," "us," "our," or "the Company" herein refer to the California corporation prior to the date of the Reincorporation, and to the Delaware corporation on and after the date of the Reincorporation. We currently operate in four business segments; see Note 10 for further details.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of NovaBay Pharmaceuticals, Inc. have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for interim reporting including the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. These statements do not include all disclosures for annual audited financial statements required by accounting principles generally accepted in the United States of America ("U.S. GAAP") and should be read in conjunction with the Company's audited consolidated financial

statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The consolidated balance sheet at December 31, 2013, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

The Company believes these consolidated financial statements reflect all adjustments (consisting only of normal, recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations for the periods presented. Results of operations for the interim periods presented are not necessarily indicative of results to be expected for the year.

The financial statements have been prepared under the guidelines for Development Stage Entities. A development stage enterprise is one in which planned principal operations have not commenced, or if its operations have commenced, there have been no significant revenues therefrom. As of September 30, 2014, we continued to conduct clinical trials and had not commenced our planned principal operations.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, NovaBay Pharmaceuticals Canada, Inc. (prior to its dissolution in July 2012) and DermaBay, Inc. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization period for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid instruments with a stated maturity of three months or less at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates their fair value. As of September 30, 2014, the Company's cash and cash equivalents were held in financial institutions in the United States and include deposits in money market funds, which were unrestricted as to withdrawal or use.

6

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company classifies all highly liquid investments with a stated maturity of greater than three months at the date of purchase as short-term investments. Short-term investments generally consist of municipal and corporate debt securities. The Company has classified its short-term investments as available-for-sale. The Company does not intend to hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value below cost of any available-for-sale security that is determined to be other-than-temporary results in a revaluation of its carrying amount to fair value and an impairment charge to earnings, resulting in a new cost basis for the security. No such impairment charges were recorded for the periods presented. The interest income and realized gains and losses are included in other income (expense), net within the consolidated statements of operations and comprehensive loss. Interest income is recognized when earned.

Concentrations of Credit Risk and Major Partners

Financial instruments which potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents and short-term investments. The Company maintains deposits of cash, cash equivalents and short-term investments with three highly-rated, major financial institutions in the United States.

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, the Company has established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During the three months ended September 30, 2014, revenues were derived from two distribution partners, service revenues and sales of i-Lid Cleanser and NeutroPhase. During the three months ended September 30, 2013, revenues were derived from two collaboration partners, two distribution partners, service revenues and sales of NeutroPhase.

During the nine months ended September 30, 2014, revenues were derived from one collaboration partner, two distribution partners, service revenues and sales of i-Lid Cleanser and NeutroPhase. During the nine months ended September 30, 2013, revenues were derived from two collaboration partners, two distribution partners, service revenues and sales of NeutroPhase.

As of September 30, 2014, 48% and 14% of accounts receivable was derived from two distribution partners and 15% of accounts receivable was derived from a vendor to which the Company sold equipment in June 2014. As of December 31, 2013, 98% of accounts receivable was derived from one collaboration partner and one distribution partner.

Comprehensive Income (Loss)

ASC 220, *Comprehensive Income* requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. Short-term investments and our warrant liability are carried at fair value.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable;

Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions).

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for software and seven years for furniture and fixtures. Leasehold improvements are depreciated over the shorter of seven years or the lease term. Depreciation of assets recorded under capital leases is included in depreciation expense.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets and has determined that there was no impairment as of all periods presented. Determination of recoverability is based on the estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of the Company’s product candidates. The terms of the agreements typically include non-refundable upfront fees, funding of research and development activities, payments based upon

achievement of certain milestones and royalties on net product sales. In accordance with revenue recognition criteria under U.S. GAAP, the Company analyzes its multiple element arrangements to determine whether the elements can be separated. The Company performs its analysis at the inception of the arrangement and as each product or service is delivered. If a product or service is not separable, the combined deliverables are

accounted for as a single unit of accounting and revenue is recognized over the performance obligation period. Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred and risk of loss has passed; the seller's price to the buyer is fixed or determinable; and collectability is reasonably assured.

Assuming the elements meet the revenue recognition guidelines the revenue recognition methodology prescribed for each unit of accounting is summarized below:

Upfront Fees—The Company defers recognition of non-refundable upfront fees if it has continuing performance obligations without which the technology licensed has no utility to the licensee. If it has performance obligations through research and development services that are required because its know-how and expertise related to the technology is proprietary to it, or can only be performed by it, then such up-front fees are deferred and recognized over the period of the performance obligations. The Company bases the estimate of the period of performance on factors in the contract. Actual time frames could vary and could result in material changes to its results of operations.

Funded Research and Development— Revenue from research and development services is recognized during the period in which the services are performed and is based upon the number of full-time-equivalent personnel working on the specific project at the agreed-upon rate. This revenue approximates the cost incurred. Reimbursements from collaborative partners for agreed-upon direct costs including direct materials and outsourced, or subcontracted, pre-clinical studies are classified as revenue and recognized in the period the reimbursable expenses are incurred. Payments received in advance are recorded as deferred revenue until the research and development services are performed or costs are incurred.

Milestones—Substantive milestone payments are considered to be performance bonuses that are recognized upon achievement of the milestone only if all of the following conditions are met: the milestone payments are non-refundable; achievement of the milestone involves a degree of risk and was not reasonably assured at the inception of the arrangement; substantive effort is involved in achieving the milestone; the amount of the milestone is reasonable in relation to the effort expended or the risk associated with achievement of the milestone; and a reasonable amount of time passes between the up-front license payment and the first milestone payment as well as between each subsequent milestone payment. If any of these conditions are not met, the milestone payments are deferred and recognized as revenue over the term of the arrangement as we complete our performance obligations.

Royalties—The Company recognizes royalty revenues from licensed products upon the sale of the related products.

8

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Product Sales—The Company sells NeutroPhase, CelleRx and i-Lid Cleanser through a limited number of distributors and directly to customers. We generally record product sales upon shipment to distributors at which time title and risk of loss pass to the distributors.

Cost of Goods Sold

Cost of goods sold includes third party manufacturing costs, shipping costs, cost of samples and other costs of goods sold. Cost of goods sold also includes any necessary allowances for excess inventory that may expire and become unsalable.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. Research and development expenses under the collaborative agreements approximate the revenue recognized, excluding milestone and upfront payments received under such arrangements.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASC 718, *Compensation-Stock Compensation*. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model. See Note 8 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable 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. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences 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 recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liabilities

For warrants where there is a deemed possibility that the Company may have to settle the warrants in cash, the Company records the fair value of the issued warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statement of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice (“Lattice”) valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of judgment on the part of the Company.

Net Income (Loss) per Share

The Company computes net income (loss) per share by presenting both basic and diluted earnings (loss) per share (EPS).

9

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Basic EPS is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive. During the three months ended September 30, 2014 and 2013, and nine months ended September 30, 2014 and 2013, there was no difference between basic and diluted net loss per share due to the Company's net losses. The following table sets forth the calculation of basic EPS and diluted EPS:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(in thousands, except per share amounts)	**2014**	**2013**	**2014**	**2013**
Net loss	$(4,219)	$(3,848)	$(10,726)	$(11,905)
Basic shares	50,821	37,467	48,995	37,166
Add: shares issued upon assumed exercise of stock options and warrants	—	—	—	—
Diluted shares	50,821	37,467	48,995	37,166
Basic and diluted net loss per share	$(0.08)	$(0.10)	$(0.22)	$(0.32)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation as their effect would have been anti-dilutive:

	Nine Months Ended September 30,	
(In thousands)	**2014**	**2013**

Stock options	8,181	7,181
Stock warrants	4,925	10,010
	13,106	17,191

Recent Accounting Pronouncements

In May 2014, Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09 "Revenue from Contracts with Customers" (Topic 606). The guidance of this Update effects any entities that either issues contracts with customers or transfer goods or services or enters into contracts for the transfer of non-financial assets. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in the amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. To achieve those core principals, the ASU specifies steps that the entity should apply for revenue recognition. The guidance also specifies the accounting for some costs to obtain or fulfill the contract with customer and disclosure requirements to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. For a public entity, ASU No. 2014-10 is effective for annual reporting period beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company will adopt ASU No. 2014-09 on January 1, 2017. The Company is currently evaluating the impact of the adoption of the ASU on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-10 "Development Stage Entities" (Topic 915). The objective of the ASU is to improve financial reporting by reducing the cost and complexity of associated with the incremental reporting requirements for development stage entities. The ASU removes all incremental financial reporting requirements from U.S. GAAP for development stage entities, including the inception-to-date information and certain other disclosures. The ASU also eliminates an exception provided to development stage entities in Topic 810 "Consolidation" for determining whether an entity is a variable interest entity on the basis of amount of investment equity at risk. For public business entities, those amendments are effective for annual reporting periods beginning after December 15, 2014, and interim periods therein. Early application of the amendments is permitted for any annual or interim reporting period for which the entity's financial statements have not been issued. The Company will adopt ASU No. 2014-10 on January 1, 2015. The adoption will have a material impact on the Company's consolidated financial statements. The Company will no longer present incremental disclosure for development stage entities in its Annual Report on Form 10-K for the year ended December 31, 2014 and subsequently issued Forms 10-Q and 10-K, including consolidated financial statements for the cumulative period from July 1, 2002 (inception) to the reporting date and inception-to-date disclosures.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In June 2014, the FASB issued ASU No. 2014-12 “Compensation – Stock Compensation” (Topic 718). The ASU provides guidance for accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. That is the case when an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target (for example, profitability target) could be achieved and still be eligible to vest in the award if and when the performance target is achieved. The amendment requires a performance target that effects vesting and that could be achieved after requisite service period be treated as a performance condition. Compensation cost should be recognized in the period in which it becomes probable that such performance condition would be achieved and should represent the compensation cost attributable to the periods for which the requisite service has already been rendered. For public business entities, those amendments are effective for annual reporting periods beginning after December 15, 2015, and interim periods therein. Early application is permitted. The Company will adopt ASU No. 2014-12 on January 1, 2016. The adoption will not have a material impact on the Company’s consolidated financial statements, as the Company currently does not have share-based payment awards, which are subject to ASU No. 2014-12.

In August 2014, the FASB issued ASU No. 2014-15 “Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern”. All entities are required to apply the new requirements in annual periods ending after December 15, 2016, and interim periods thereafter. Early application is permitted. The Company will adopt ASU No. 2014-15 on January 1, 2016. The adoption of this ASU will not have a material impact on the Company’s consolidated financial statements.

NOTE 3. INVESTMENTS

Short-term investments at September 30, 2014, and December 31, 2013, consisted of the following:

	September 30, 2014			
(in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Market Value**

Corporate bonds	$360	$ —	$ (9)	$ 351
Certificates of deposit	900	—	—	900
	$1,260	$ —	$ (9)	$ 1,251

	December 31, 2013			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Corporate bonds	$518	$ —	$ (14)	$ 504
Certificates of deposit	2,050	—	(1)	2,049
	$2,568	$ —	$ (15)	$ 2,553

All short-term investments at September 30, 2014, and December 31, 2013, mature in less than one year. Unrealized holding gains and losses classified as available-for-sale are recorded in accumulated other comprehensive loss.

The Company recognized realized losses of $11,000 and $5,000 for the three months ended September 30, 2014 and 2013, respectively. The Company recognized realized losses of $29,000 and $19,000, for the nine months ended September 30, 2014 and 2013, respectively.

NOTE 4. FAIR VALUE MEASUREMENTS

The Company’s cash equivalents and investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices in active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of investments that are generally classified within Level 1 of the fair value hierarchy include money market securities. The types of investments that are generally classified within Level 2 of the fair value hierarchy include corporate and municipal securities and certificates of deposits.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company's warrant liabilities are classified within level 3 of the fair value hierarchy because the value is calculated using significant judgment based on our own assumptions in the valuation of these liabilities.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2014:

		Fair Value Measurements Using		
(in thousands)	**Balance at September 30, 2014**	**Quoted Prices in Active Markets for Identical Items (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets				
Short-term investments:				
Corporate bonds	$351	—	351	—
Certificates of deposit	900	—	900	—
Total short-term investments	1,251	—	1,251	—
Total assets	$1,251	$ —	$ 1,251	$ —
Liabilities				
Warrant liability	$624	$ —	$ —	$ 624
Total liabilities	$624	$ —	$ —	$ 624

For the three and nine month periods ended September 30, 2014, as a result of the fair value adjustment of the warrant liability, the Company recorded a noncash loss on an increase in the fair value of the warrants of $104,000 and a

noncash gain on a decrease in the fair value of the warrants of $1.2 million, respectively, in its consolidated statement of operations and comprehensive loss.

For the three and nine month periods ended September 30, 2013, as a result of the fair value adjustment of the warrant liability, the Company recorded a non-cash loss on an increase in the fair value of the warrants of $866,000 and $1.3 million, respectively, in its consolidated statement of operations and comprehensive loss. See Note 6 for further discussion on the calculation of the fair value of the warrant liability.

(in thousands)	**Warrant liability**
Fair value of warrants at December 31, 2013	$ 1,837
Adjustment to fair value at September 30, 2014	(1,213)
Total warrant liability at September 30, 2014	$ 624

NOTE 5. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases laboratory facilities and office space under an operating lease which will expire on October 31, 2020. Rent expense was approximately $255,000 and $251,000 for the three months ended September 30, 2014 and 2013, respectively. Rent expense was approximately $790,000 and $716,000 for the nine months ended September 30, 2014 and 2013, respectively

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The Company’s monthly rent payments fluctuate under the master lease agreement. In accordance with U.S. GAAP, the Company recognizes rent expense on a straight-line basis. The Company records deferred rent for the difference between the amounts paid and recorded as expense.

Directors and Officers Indemnity

As permitted under Delaware law and in accordance with its bylaws, the Company shall indemnify its officers and directors for certain events or occurrences while the officer or director is or was serving at its request in such capacity. The term of the indemnification period is for the officer’s or director’s lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a director or officer insurance policy that limits its exposure and may enable them to recover a portion of any future payments. The Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liability has been recorded for these agreements as of

September 30, 2014.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In the normal course of business, the Company provides indemnifications of varying scope under agreements with other companies, typically its clinical research organizations, investigators, clinical sites, suppliers and others. Pursuant to these agreements, the Company generally indemnifies, holds harmless, and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified parties in connection with use or testing of its products or product candidates or with any U.S. patent or any copyright or other intellectual property infringement claims by any third party with respect to their products. The term of these indemnification agreements is generally perpetual. The potential future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, costs related to these indemnification provisions have been immaterial. The Company also maintains various liability insurance policies that limit its exposure. As a result, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of September 30, 2014.

Legal Matters

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at September 30, 2014, that, in the opinion of management, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6. WARRANT LIABILITY

In July 2011, the Company sold common stock and warrants in a registered direct financing. As part of this transaction, 3,488,005 warrants were issued with an exercise price of $1.33 and were exercisable on January 1, 2012, and expire on July 5, 2016. The terms of the warrants require registered shares to be delivered upon each warrant's exercise and also require possible cash payments to the warrant holders (in lieu of the warrant's exercise) upon specified fundamental transactions involving the Company's common stock, such as in an acquisition of the Company. Under ASC 480, "Distinguishing Liabilities from Equity" ("ASC 480"), the Company's ability to deliver registered shares upon an exercise of the warrants and the Company's potential obligation to cash-settle the warrants if specified fundamental transactions occur are deemed to be beyond the Company's control. The warrants contain a provision where the warrant holder would have the option to receive cash, equal to the Black-Scholes fair value of the remaining unexercised portion of the warrant, as cash settlement in the event that there is a fundamental transaction

(contractually defined to include various merger, acquisition or stock transfer activities). Due to this provision, ASC 480 requires that these warrants be classified as liabilities. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model, and the changes in the fair value are recorded in the consolidated statement of operations and comprehensive loss. The Lattice model provides for assumptions regarding volatility and risk-free interest rates within the total period to maturity. In addition, after January 5, 2012, and if the closing bid price per share of the common stock on the principal market equals or exceeds $2.66 for any ten trading days (which do not need to be consecutive) in a period of fifteen consecutive trading days, the Company has the right to require the exercise of one-third of the warrants then held by the warrant holders, which would result in gross proceeds to the Company of approximately $1.5 million.

The key assumptions used to value the warrants were as follows:

	September 30,	
Assumption	**2014**	**2013**
Expected price volatility	70%	55%
Expected term (in years)	1.76	2.76
Risk-free interest rate	0.47%	0.56%
Dividend yield	0.00%	0.00%
Weighted-average fair value of warrants	$0.18	$0.74

NOTE 7. STOCKHOLDERS' EQUITY

On July 5, 2011, the Company closed a registered direct offering for the sale of 4,650,675 units (The "July 2011 Registered Direct Financing"), each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 3,488,005 shares), at a purchase price of $1.11 per unit. The warrants will be exercisable 180 days after issuance for $1.33 per share and will expire five years from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the July 2011 Registered Direct Offering. The Company raised a total of $5.2 million from the July 2011 Registered Direct Financing, or approximately $4.6 million in net proceeds after deducting underwriting commissions of $288,000 and other offering costs of $244,000.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On December 6, 2012, the Company closed a public offering for the sale of 5,900,000 shares of common stock and 5,900,000 warrants to purchase 0.75 of a share of common stock (or a total of 4,425,000 shares), at a purchase price of $1.25 per share with associated warrant. The warrants were immediately exercisable for $1.50 per share and will expire one year from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of $7.4 million from this offering, or approximately $6.6 million in net proceeds after deducting underwriting commissions of $479,000 and other offering costs of $240,000.

On November 14, 2013, the Company entered into an At-The-Market Offering Agreement (“ATM Agreement”), with Ascendiant Capital Markets (“Ascendiant”), as its agent, and filed a prospectus supplement to its shelf registration statement, pursuant to which the Company may offer and sell shares of our common stock having an aggregate offering price of up to $5.0 million from time to time. For the year ended December 31, 2013, the Company sold 289,492 shares for gross proceeds of $378,000, or approximately $352,000 in net proceeds after deducting offering costs and commissions of $26,000. For the nine months ended September 30, 2014, the Company sold 796,412 shares for gross proceeds of $807,000, or approximately $726,000 in net proceeds after deducting offering costs and commissions of $81,000. Under the terms of the ATM Agreement, the Company paid to Ascendiant 3% of the gross proceeds of all sales made under the ATM Agreement.

On October 16, 2014, the Company entered into an At-The-Market Offering Agreement with Ascendiant under which we may offer and sell our common stock having aggregate sales proceeds of up to $10.0 million from time to time through Ascendiant as our sales agent. In connection with the new agreement we terminated the At-The-Market Offering Agreement with Ascendiant dated November 13, 2013. See Note 11 for details of the new agreement with Ascendiant.

On December 2, 2013 the Company entered into a stock purchase agreement with Pioneer to purchase five million shares of NovaBay stock at $1.14 per share, resulting in cash proceeds to NovaBay of $5.7 million.

On March 25, 2014, the Company closed a public offering for the sale of 5,600,000 units, each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.25 of a share of common stock (or a total of 1,400,000 shares), at a purchase price of $1.20 per unit. The warrants were immediately exercisable for $1.56 per share and will expire eighteen months from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of $6.7 million from this offering, or approximately $6.0 million in net proceeds after deducting underwriting commissions of $470,000 and other offering costs of $211,000.

Stock Warrants

On August 21, 2014, warrants to purchase 1,225,000 shares of common stock, issued in connection with our August 2009 shelf offering, with an exercise price of $2.75 per share, expired.

In July 2011, 3,488,005 warrants were issued in connection with our July 2011 Registered Direct Financing. These warrants were issued with an exercise price of $1.33 and expire on July 5, 2016. These outstanding warrants were fully exercisable at September 30, 2014. During 2012, 22,500 of these warrants were exercised and the Company received $30,000 in cash upon exercise of the warrants.

In January 2012, warrants to purchase 60,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share for 30,000 of the shares and $3.75 per share for the remaining 30,000 shares and became exercisable monthly through September 30, 2012, were fully exercisable on September 30, 2014, and expire on January 2, 2016. The warrants were valued at approximately $34,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 75% and 89%, respectively, (2) a risk-free interest rate of 0.30% and 0.36% respectively and (3) an expected life of 2.36 and 2.98 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three and nine months ended September 30, 2014 and 2013, related to these warrants.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In October 2012, warrants to purchase 15,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share and 5,000 shares became exercisable on each of October 30, 2012, November 30, 2012, and December 30, 2012, and they all expired on September 30, 2014. The warrants were valued at approximately $4,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 72%, (2) a risk-free interest rate of 0.27% and (3) an expected life of 2.00 years. The Company accounted for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three and nine months ended September 30, 2014 and 2013, related to these warrants.

In March 2014, 1,400,000 warrants were issued in connection with our March Financing. These warrants were issued with an exercise price of $1.56 and expire on September 25, 2015. These outstanding warrants were fully exercisable at September 30, 2014.

The details of all outstanding warrants as of September 30, 2014, are as follows:

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2013	4,765	$ 1.72
Warrants issued	1,400	$ 1.56
Warrants expired	(1,240)	$ (2.75)
Outstanding at September 30, 2014	4,925	$ 1.42

NOTE 8. EQUITY-BASED COMPENSATION

Equity Compensation Plans

Prior to our Initial Public Offering (IPO), the Company had two equity plans in place: the 2002 Stock Option Plan and the 2005 Stock Option Plan. Upon the closing of the IPO in October 2007, the Company adopted the 2007 Omnibus Incentive Plan (the "2007 Plan") to provide for the granting of stock awards, such as stock options, unrestricted and restricted common stock, stock units, dividend equivalent rights, and stock appreciation rights to employees, directors and outside consultants as determined by the board of directors. In conjunction with the adoption of the 2007 Plan, no further option awards may be granted from the 2002 or 2005 Stock Option Plans and any option cancellations or expirations from the 2002 or 2005 Stock Option Plans may not be reissued. As of September 30, 2014, there were 579,062 shares available for future grant under the 2007 Plan.

Under the terms of the 2007 Plan, the exercise price of incentive stock options may not be less than 100% of the fair market value of the common stock on the date of grant and, if granted to an owner of more than 10% of the Company's stock, then not less than 110%. Stock options granted under the 2007 Plan expire no later than ten years from the date of grant. Stock options granted to employees generally vest over four years while options granted to directors and consultants typically vest over a shorter period, subject to continued service. All of the options granted prior to October 2007 include early exercise provisions that allow for full exercise of the option prior to the option vesting, subject to certain repurchase provisions. The Company issues new shares to satisfy option exercises under the plans.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Based Compensation Summary

The following table summarizes information about the Company's stock options and restricted stock units outstanding at September 30, 2014, and activity during the nine-month period then ended:

(in thousands, except years and per share data)	**Stock Awards**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Life (years)**	**Aggregate Intrinsic Value**
Outstanding at December 31, 2013	7,164	$ 1.66		
Options granted	1,687	$ 0.90		
Restricted stock units granted	71	$ —		
Options exercised	(61)	$ 0.56		
Restricted stock units vested	(56)	$ —		
Restricted stock units forfeited/cancelled	(3)	$ —		
Options forfeited/cancelled	(545)	$ 1.36		
Outstanding at September 30, 2014	8,257	$ 1.53	6.55	$ 153
Vested and expected to vest at September 30, 2014	7,822	$ 1.56	6.42	$ 140
Vested at September 30, 2014	5,743	$ 1.72	5.46	$ 23
Exercisable at September 30, 2014	5,743	$ 1.72	5.46	$ 23

As of September 30, 2104, total unrecognized compensation cost related to unvested stock options and restricted stock units was $1.5 million. This amount is expected to be recognized as stock-based compensation expense in the Company's consolidated statements of operations and comprehensive loss over the remaining weighted average vesting period of 2.82 years.

Stock Options and Awards to Employees and Directors

The Company grants options to purchase common stock to its employees and directors at prices equal to or greater than the market value of the stock on the dates the options are granted. The Company has estimated the value of stock option awards as of the date of grant by applying the Black-Scholes-Merton option pricing model using the single-option valuation approach. The application of this valuation model involves assumptions that are judgmental and subjective in nature. See Note 2 for a description of the accounting policies that the Company applied to value its stock-based awards.

During the nine months ended September 30, 2014 and 2013, the Company granted options to purchase an aggregate of 1.3 million shares of common stock to employees and directors.

The weighted-average assumptions used in determining the value of options are as follows:

	Nine months ended September 30,	
Assumption	**2014**	**2013**
Expected price volatility	77%	80%
Expected term (in years)	6.50	5.07
Risk-free interest rate	2.05%	1.13%
Dividend yield	0.00%	0.00%
Weighted-average fair value of options granted during the period	$0.62	$0.92

Additionally, during the nine mont