

ACACIA RESEARCH CORP
Form 10-Q
November 09, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

Commission File Number 0-26068

ACACIA RESEARCH CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

95-4405754
(I.R.S. Employer
Identification No.)

**500 Newport Center Drive, Newport
Beach, CA**
(Address of Principal Executive Offices)

92660
(Zip Code)

Registrant's telephone number, including area code: **(949) 480-8300**

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 filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of October 31, 2006, 28,020,042 shares of Acacia Research-Acacia Technologies common stock were issued and

outstanding. As of October 31, 2006, 41,507,579 shares of Acacia Research-CombiMatrix common stock were issued and outstanding.

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*NOTE: We are presenting the Acacia Research Corporation consolidated unaudited interim financial statements and the separate unaudited interim financial statements for the CombiMatrix group and the Acacia Technologies group. The separate financial statements and accompanying notes of the two groups are being provided as additional disclosure regarding the financial performance of the two divisions and to provide investors with information regarding the potential value and operating results of the respective businesses, which may affect the respective share values. The separate financial statements should be reviewed in conjunction with Acacia Research Corporation's consolidated financial statements and accompanying notes. The presentation of separate financial statements is not intended to indicate that we have changed the title to any of our assets or changed the responsibility for any of our liabilities, nor is it intended to indicate that the rights of our creditors have been changed. Acacia Research Corporation, and not the individual groups, is the issuer of the securities. Holders of the two securities are stockholders of Acacia Research Corporation and do not have a separate and exclusive interest in the respective groups.

ACACIA RESEARCH CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share information)
(Unaudited)

ASSETS	September 30, 2006	December 31, 2005
Current assets:		
Cash and cash equivalents	\$ 27,791	\$ 20,164
Short-term investments	26,511	39,009
Accounts receivable	2,762	5,332
Prepaid expenses, inventory, and other assets	1,955	2,115
Total current assets	59,019	66,620
Property and equipment, net of accumulated depreciation	2,259	2,484
Patents, net of accumulated amortization	26,931	31,712
Goodwill	17,039	18,980
Other assets	2,747	1,638
	\$ 107,995	\$ 121,434
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 5,883	\$ 3,924
Royalties and legal fees payable	2,343	3,758
Current portion of deferred revenues	930	804
Total current liabilities	9,156	8,486
Deferred income taxes	-	2,701
Deferred revenues, net of current portion	1,145	1,439
Other liabilities	736	1,464
Total liabilities	11,037	14,090
Commitments and contingencies (Note 10)		
Minority interests	-	447
Redeemable stockholders' equity:		
Preferred stock		
Acacia Research Corporation, par value \$0.001 per share; 10,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock		
Acacia Research - Acacia Technologies stock, par value \$0.001 per share; 50,000,000 shares authorized; 28,017,459 and 27,722,242 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively	28	28
Acacia Research - CombiMatrix stock, par value \$0.001 per share; 50,000,000 shares authorized; 41,405,798 and 38,992,402 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively	41	39

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Additional paid-in capital	321,604	315,146
Deferred stock compensation	-	(1,400)
Accumulated comprehensive income	16	(2)
Accumulated deficit	(224,731)	(206,914)
Total stockholders' equity	96,958	106,897
	\$ 107,995	\$ 121,434

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

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ACACIA RESEARCH CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(In thousands, except share and per share information)
(Unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Revenues:				
License fees	\$ 8,424	\$ 6,783	\$ 27,512	\$ 11,328
Government contract	725	973	1,563	2,985
Products	968	453	3,050	1,298
Service contracts	151	37	268	106
Total revenues	10,268	8,246	32,393	15,717
Operating expenses:				
Cost of government contract				
revenues	684	920	1,476	2,820
Cost of product sales	412	282	973	635
Research and development expenses (including non-cash stock compensation expense of \$311 and \$797 for the three and nine months ended September 30, 2006 and \$0 for the three and nine months ended September 30, 2005)	2,819	1,527	7,380	4,082
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$1,262 and \$3,881 for the three and nine months ended September 30, 2006 and \$88 and (\$23) for the three and nine months ended September 30, 2005)	6,315	4,918	20,086	12,957
Legal expenses - patents	2,354	1,076	3,803	2,173
Inventor royalties and contingent legal fees expense - patents	2,623	3,939	12,741	5,706
Inventor royalties - V-chip	-	225	-	225
Amortization of patents	1,596	1,607	4,813	4,407
Write-off of patent-related intangible asset	-	-	297	-
Legal settlement credits	-	(211)	-	(406)
Loss from equity investments	253	100	786	202
Total operating expenses	17,056	14,383	52,355	32,801
Operating loss	(6,788)	(6,137)	(19,962)	(17,084)
Other income (expense):				
Interest and investment income	501	434	1,572	1,090
Loss on sale of interest in subsidiary	-	-	(84)	-
Warrant gains (charges)	913	163	663	163
Total other income, net	1,414	597	2,151	1,253

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Loss from continuing operations before income taxes and minority interests	(5,374)	(5,540)	(17,811)	(15,831)
(Provision) benefit for income taxes	(2)	98	(6)	232
Loss from continuing operations before minority interests	(5,376)	(5,442)	(17,817)	(15,599)
Minority interests	-	1	-	1
Loss from continuing operations	(5,376)	(5,441)	(17,817)	(15,598)
Discontinued operations:				
Estimated loss on disposal of discontinued operations	-	-	-	(210)
Net loss	(5,376)	(5,441)	(17,817)	(15,808)
Unrealized gains (losses) on short-term investments	70	(5)	73	2
Unrealized gains on foreign currency translation	2	14	6	36
Sale of interest in subsidiary's cumulative translation adjustment	-	-	(61)	-
Comprehensive loss	\$ (5,304)	\$ (5,432)	\$ (17,799)	\$ (15,770)
Earnings (loss) per common share:				
Attributable to the Acacia Technologies group:				
Loss from continuing operations	\$ (1,049)	\$ (1,558)	\$ (2,359)	\$ (4,982)
Basic and diluted loss per share	(0.04)	(0.06)	(0.09)	(0.19)
Loss from discontinued operations	\$ -	\$ -	\$ -	\$ (210)
Basic and diluted loss per share	-	-	-	(0.01)
Net loss	\$ (1,049)	\$ (1,558)	\$ (2,359)	\$ (5,192)
Basic and diluted loss per share	(0.04)	(0.06)	(0.09)	(0.20)
Attributable to the CombiMatrix group:				
Net loss	\$ (4,327)	\$ (3,883)	\$ (15,458)	\$ (10,616)
Basic and diluted loss per share	(0.11)	(0.12)	(0.39)	(0.33)
Weighted average shares:				
Acacia Research - Acacia Technologies stock:				
Basic and diluted	27,567,848	27,302,693	27,492,410	26,387,562
Acacia Research - CombiMatrix stock:				

Basic and diluted	40,209,640	33,239,726	39,411,421	31,887,872
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The accompanying notes are an integral part of these consolidated financial statements.

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ACACIA RESEARCH CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Nine Months Ended	
	September 30,	September 30,
	2006	2005
Cash flows from operating activities:		
Net loss	\$ (17,817)	\$ (15,808)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,553	5,260
Minority interests	-	3
Non-cash stock compensation	4,678	(23)
Deferred income taxes	(70)	(210)
Non-cash warrant charges (gains)	(663)	(163)
Non-cash legal settlement charges (credits)	-	(406)
Loss on disposal of discontinued operations	-	210
Write-off of patent-related intangible asset	297	-
Loss from equity investments	786	253
Loss on sale of interest in subsidiary	84	-
Stock issued to consultant	94	-
Other	42	(128)
Changes in assets and liabilities, excluding effect of business acquisition:		
Accounts receivable	2,553	(986)
Prepaid expenses, inventory and other assets	(213)	(576)
Accounts payable and accrued expenses	2,285	574
Royalties and legal fees payable	(1,415)	1,331
Deferred revenues	(115)	375
Net cash used in operating activities from continuing operations	(3,921)	(10,294)
Net cash provided by (used in) operating activities from discontinued operations	222	(525)
Net cash used in operating activities	(3,699)	(10,819)
Cash flows from investing activities:		
Purchase of property and equipment	(619)	(1,162)
Purchase of available-for-sale investments	(14,927)	(57,309)
Sale of available-for-sale investments	27,485	59,260
Business acquisition (Note 7)	(16)	(5,796)
Purchase of additional interests in equity method investee	(1,400)	(1,100)
Patent acquisition costs	(1,020)	(445)
Sale of interest in subsidiary (net of cash disposed)	(369)	-
Net cash provided by (used in) investing activities	9,134	(6,552)
Net cash used in investing activities from discontinued operations	(353)	-
Net cash provided by (used in) investing activities	8,781	(6,552)
Cash flows from financing activities:		
Proceeds from sale of common stock, net of issuance costs	2,640	32,354
Prepaid Standby Equity Distribution Agreement commitment fees (Note 6)	(550)	-
Proceeds from the exercise of stock options	455	187

Net cash provided by financing activities	2,545	32,541
Effect of exchange rate on cash	-	35
Increase in cash and cash equivalents	7,627	15,205
Cash and cash equivalents, beginning	20,164	13,910
Cash and cash equivalents, ending	\$ 27,791	\$ 29,115

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

ACACIA RESEARCH CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business. Acacia Research Corporation (“we,” “us” and “our”) is comprised of two operating groups.

Acacia Technologies Group

The Acacia Technologies group, a division of Acacia Research Corporation, develops, acquires, licenses and enforces patented technologies. The Acacia Technologies group owns and has rights to patent portfolios covering a wide range of technology areas. The Acacia Technologies group is primarily comprised of certain of Acacia Research Corporation’s direct and or indirect wholly owned subsidiaries and limited liability companies including:

- Acacia Global Acquisition Corporation
- Acacia Media Technologies Corporation
- Acacia Patent Acquisition Corporation
- Acacia Technologies Services Corporation
- AV Technologies LLC
- Broadcast Data Retrieval Corporation
- Broadcast Innovation LLC
- Computer Acceleration Corporation
- Computer Cache Coherency Corporation
- Computer Docking Station Corporation
- Credit Card Fraud Control Corporation
- Data Encryption Corporation
- Data Innovation LLC
- Diagnostic Systems Corporation
- Disk Link Corporation
- Financial Systems Innovation LLC
- High Resolution Optics Corporation
- Information Technology Innovation LLC
- InternetAd LLC
- IP Innovation LLC
- KY Data Systems LLC
- Micromesh Technology Corporation
- Microprocessor Enhancement Corporation
- New Medium LLC
- Peer Communications Corporation
- Product Activation Corporation
- Resource Scheduling Corporation
- Software Collaboration Corporation
- Soundview Technologies, Inc.
- Spreadsheet Automation Corporation
- TechSearch LLC
- Telematics Corporation
- VData LLC

The Acacia Technologies group also includes all corporate assets, liabilities, and related transactions of Acacia Research Corporation attributed to Acacia Research Corporation’s intellectual property licensing and enforcement business. Refer to “Business Acquisition” below for information on the Acacia Technologies group’s 2005 business acquisition activity.

Business Acquisition. On January 28, 2005, Acacia Global Acquisition Corporation acquired the assets of Global Patent Holdings, LLC, which owned 11 patent licensing companies (“GPH Acquisition”). The acquisition provided the Acacia Technologies group ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. Refer to Note 7 for a description of the acquisition transaction.

CombiMatrix Group

Our life sciences business, referred to as the “CombiMatrix group,” a division of Acacia Research Corporation, is comprised of our wholly owned subsidiary, CombiMatrix Corporation and CombiMatrix Corporation’s wholly owned subsidiary, CombiMatrix Molecular Diagnostics and includes all corporate assets, liabilities and transactions related to Acacia Research Corporation’s life sciences business.

The CombiMatrix group develops proprietary technologies and products and services in the areas of drug development, genetic analysis, nanotechnology research, defense and homeland security markets, and other markets where its products could be utilized. Among the technologies being developed by the CombiMatrix group is a platform technology to produce customizable arrays, which are semiconductor-based tools for use in identifying and determining the roles of genes, gene mutations and proteins. This technology has potential applications in the areas of genomics, proteomics, biosensors, drug discovery, drug development, diagnostics, combinatorial chemistry, material sciences and nanotechnology. Other technologies include proprietary molecular synthesis and screening methods for the discovery of potential new drugs. CombiMatrix Molecular Diagnostics, Inc., (“CMDX”), a wholly owned subsidiary located in Irvine, California, is exploring opportunities for the CombiMatrix group’s arrays in the field of molecular diagnostics. CombiMatrix K.K., a Japanese corporation located in Tokyo, Japan, has existed for the purpose of exploring opportunities for CombiMatrix Corporation’s array system with pharmaceutical and biotechnology companies in the Asian market. In January 2006, CombiMatrix Corporation sold 67% of its ownership interest in CombiMatrix K.K. to a third party. Refer to Note 12.

ACACIA RESEARCH CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Other

In January 2006, Acacia Research Corporation's board of directors approved a plan for its wholly owned subsidiary, CombiMatrix Corporation, to become an independent public company. The transaction is expected to be completed no sooner than the first quarter of 2007, subject, however, to determination that there are no significant negative tax consequences to Acacia Research Corporation or its shareholders and completing the required filings with the Securities and Exchange Commission, or SEC. We have received a private letter ruling from the IRS addressing certain tax implications of the transaction and have requested a tax opinion from counsel. If the conditions are met, Acacia Research Corporation will redeem all of the issued and outstanding shares of AR-CombiMatrix common stock for all of the common stock of CombiMatrix Corporation, which will register its common stock under the Securities and Exchange Act of 1934. Following the redemption, CombiMatrix Corporation will apply to list its shares for trading on a national exchange.

Capital Structure. On December 11, 2002, our stockholders voted in favor of a recapitalization transaction, which became effective on December 13, 2002, whereby we created two new classes of common stock called Acacia Research-CombiMatrix common stock ("AR-CombiMatrix stock") and Acacia Research-Acacia Technologies common stock ("AR-Acacia Technologies stock"), and divided our existing Acacia Research Corporation common stock into shares of the two new classes of common stock. AR-CombiMatrix stock is intended to reflect separately the performance of Acacia Research Corporation's CombiMatrix group. AR-Acacia Technologies stock is intended to reflect separately the performance of Acacia Research Corporation's Acacia Technologies group. Although the AR-CombiMatrix stock and the AR-Acacia Technologies stock are intended to reflect the performance of our different business groups, they are both classes of common stock of Acacia Research Corporation and are not stock issued by the respective groups.

Liquidity and Risks

General. To date, we and our subsidiaries have relied primarily upon selling equity securities and payments from our strategic partners and licensees to generate the funds needed to finance the implementation of our plans of operation for our subsidiaries.

Management believes that the Acacia Technologies group's cash and cash equivalent balances, anticipated cash flow from operations and other external sources of available credit will be sufficient to meet our cash requirements through at least November 2007.

Management believes that the CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit, including the standby equity distribution agreement (the "SEDA"), discussed at Note 6, will be sufficient to meet its cash requirements for the next six months.

The Acacia Technologies Group. To date, the Acacia Technologies group has relied upon the receipt of license fee payments from the licensing of the Acacia Technologies group's patented technologies and the selling of Acacia Research Corporation equity securities to generate the funds needed to finance the operations of the Acacia Technologies group. The Acacia Technologies group began to commercially license its DMT® technology in 2003. The GPH Acquisition provided the Acacia Technologies group with ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. Subsequent to the GPH Acquisition, the Acacia Technologies group has acquired or acquired the rights to over 20 additional patent portfolios, covering a wide range of technology areas, which it intends to develop, license and enforce.

There can be no assurance that the Acacia Technologies group will be able to implement its future plans. Failure by management to achieve its plans would have a material adverse effect on the Acacia Technologies group and on Acacia Research Corporation's ability to achieve its intended business objectives. We may be required to obtain additional financing. There can be no assurance that additional funding will be available on favorable terms, if at all. If we fail to obtain additional funding when needed, we may not be able to execute our business plans and our businesses may suffer.

ACACIA RESEARCH CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The timing of the receipt of revenues by the Acacia Technologies group's business operations are subject to certain risks and uncertainties, including:

- market acceptance of our patented technologies and services;
- business activities and financial results of our licensees;
- technological advances that may make our patented technologies obsolete or less competitive;
- increases in operating costs, including costs for legal services, engineering and research and personnel;
- the availability and cost of capital; and
- governmental regulation that may restrict the Acacia Technologies group's business.

The Acacia Technologies group's success also depends on its ability to protect its intellectual property. The Acacia Technologies group relies on its proprietary rights and their protection. Although reasonable efforts will be taken to protect the Acacia Technologies group's proprietary rights, the complexity of international trade secret, copyright, trademark and patent law, and common law, coupled with limited resources and the demands of quick delivery of technologies to market, create risk that these efforts will prove inadequate. Accordingly, if the Acacia Technologies group is unsuccessful with litigation to protect its intellectual property rights, the future revenues of the Acacia Technologies group could be adversely affected.

The CombiMatrix Group. The CombiMatrix group is deploying new and unproven technologies and continues to develop its commercial products. The CombiMatrix group has several ongoing long-term development projects that involve experimental technology and may require several years and substantial expenditures to complete. Management believes that the CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit including the SEDA will be sufficient to meet its cash requirements for the next six months. In order for the CombiMatrix group to continue as a going concern beyond March 31, 2007, the CombiMatrix group will be required to obtain capital from external sources, including the SEDA. However, based on the recent decline in the market value of AR-CombiMatrix stock, which began trading below \$1.00 per share in late September 2006, and due to the limitation of the number of shares of AR-CombiMatrix stock available on the SEDA, the CombiMatrix group may be required to seek additional sources of financing, including the issuance of debt and/or equity securities that may not be available at times and at terms acceptable to the CombiMatrix group. The issuance of equity securities will also cause dilution to the AR-CombiMatrix shareholders. If external financing sources beyond the SEDA are not available or are inadequate to fund the operations of the CombiMatrix group, it will be required to reduce its operating costs including research projects and personnel, which could jeopardize the future strategic initiatives and business plans of the CombiMatrix group. For example, reductions in research and development activities and/or personnel at our Mukilteo, Washington facility could result in the inability to invest the resources necessary to continue to develop next-generation products and improve existing product lines in order to remain competitive in the marketplace, resulting in reduced revenues and cash flows from the sales of our CustomArray products and services. Also, reduction in operating costs at our diagnostics subsidiary in Irvine, California, (CMDX), should they occur, could jeopardize its ability to launch, market and sell additional products and services necessary in order to grow and sustain its operations and eventually achieve profitability.

The ability to meet business objectives is dependent upon the CombiMatrix group's ability to raise additional financing, substantiate its technology and ultimately to fund itself from continuing operations. There can be no assurance that such funding will be available at acceptable terms or at all. The CombiMatrix group has a history of incurring net losses and net operating cash flow deficits.

The CombiMatrix group's business operations are also subject to certain risks and uncertainties, including:

- market acceptance of products and services;

- technological advances that may make its products and services obsolete or less competitive;
- increases in operating costs, including costs for supplies, personnel and equipment;
- the availability and cost of capital; and
- governmental regulation that may restrict its business.

Historically, the CombiMatrix group has been substantially dependent on arrangements with strategic partners and has relied upon payments by its partners for a significant component of its working capital. The CombiMatrix group intends to enter into additional strategic partnerships to develop and commercialize future products. However, there can be no assurance that the CombiMatrix group will be able to implement its future plans. Failure to achieve its plans would have a material adverse effect on the CombiMatrix group's and on Acacia Research Corporation's ability to achieve their intended business objectives. The CombiMatrix group also depends on its ability to protect its intellectual property; the loss thereof or the CombiMatrix group's failure to secure the issuance of additional patents covering elements of its business processes could materially harm its business and financial condition. The patents covering the CombiMatrix group's core technology begin to expire in 2018.

ACACIA RESEARCH CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The CombiMatrix group's products and services are concentrated in a highly competitive market that is characterized by rapid technological advances, frequent changes in customer requirements and evolving regulatory requirements and industry standards. Failure to anticipate or respond adequately to technological advances, changes in customer requirements, changes in regulatory requirements or industry standards, or any significant delays in the development or introduction of planned products or services, could have a material adverse effect on the CombiMatrix group's business and operating results.

Acacia Research Corporation's cash and cash equivalent and short term investment balances, cash flows and anticipated cash flows from operations and other sources of external credit, are attributed to the Acacia Technologies group and the CombiMatrix group based on the respective assets of the specific businesses comprising each group. Issuances of AR-Acacia Technologies stock (and the proceeds thereof) are attributed to the Acacia Technologies group and issuances of AR-CombiMatrix stock (and the proceeds thereof) are attributed to the CombiMatrix group. Neither of the groups is obligated to fund the ongoing operations of the other group. Management has no intent to use the cash and cash equivalent balances, anticipated cash flow from operations, and other external sources of available credit of one group to fund the ongoing operations of the other group.

Basis of Presentation. The accompanying unaudited consolidated financial statements include the accounts of Acacia Research Corporation and its wholly owned and majority-owned subsidiaries and investments accounted for under the equity method. Material intercompany transactions and balances have been eliminated in consolidation.

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnotes required by generally accepted accounting principles in annual financial statements have been omitted or condensed in accordance with quarterly reporting requirements of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2005, as reported by us in our Annual Report on Form 10-K. The year-end consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The consolidated financial statements of Acacia Research Corporation include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair statement of our financial position as of September 30, 2006, and results of operations and cash flows for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the entire year.

Separate Group Presentation. AR-CombiMatrix stock and AR-Acacia Technologies stock are intended to reflect the separate performance of the respective division of Acacia Research Corporation. The CombiMatrix group and the Acacia Technologies group are not separate legal entities. Holders of AR-CombiMatrix stock and AR-Acacia Technologies stock are stockholders of Acacia Research Corporation. As a result, holders of AR-CombiMatrix stock and AR-Acacia Technologies stock continue to be subject to all of the risks of an investment in Acacia Research Corporation and all of its businesses, assets and liabilities. The assets of Acacia Research Corporation attributes to one of the groups could be subject to the liabilities of the other group. The group financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America, and taken together, comprise all the accounts included in the corresponding consolidated financial statements of Acacia Research Corporation. The financial statements of the groups reflect the financial position, results of operations, and cash flows of the businesses included therein. The financial statements of the groups include the accounts or assets of Acacia Research Corporation specifically attributed to the groups and were prepared using amounts included in Acacia Research Corporation's consolidated financial statements.

Minority interests represent participation of other stockholders in the net equity and in the division earnings and losses of the groups and are reflected in the caption "Minority interests" in the group financial statements. Minority interests adjust group net results of operations to reflect only the group's share of the division earnings or losses of non-wholly owned investees.

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ACACIA RESEARCH CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Financial effects arising from one group that affect Acacia Research Corporation's results of operations or financial condition could, if significant, affect the results of operations or financial condition of the other group and the market price of the class of common stock relating to the other group. Any division net losses of the CombiMatrix group or of the Acacia Technologies group, and dividends or distributions on, or repurchases of, AR-CombiMatrix stock or AR-Acacia Technologies stock, will reduce the assets of Acacia Research Corporation legally available for payment of dividends on AR-CombiMatrix stock or AR-Acacia Technologies stock.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Revision in the Classification of Certain Securities. In connection with the preparation of the 2005 consolidated financial statements, Acacia Research Corporation concluded that it was appropriate to classify its annuity investments as current investments. Prior to 2005, such investments had been classified as cash and cash equivalents. Accordingly, we have made adjustments to our consolidated statement of cash flows for the nine months ended September 30, 2005, to reflect the gross purchases of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported statements of cash flows, and it does not affect our previously reported statements of operations for any period.

As of September 30, 2005, before this revision in classification, \$4,933,000 of these current investments were classified as cash and cash equivalents on our consolidated balance sheet. There were no material purchases or sales of annuity investments during any of the periods presented, as such, the impact of the revision in classification on consolidated cash flows from investing activities was not material for any of the periods presented.

Concentrations. Two and three licensee(s) individually accounted for greater than 10% of the Acacia Technologies group's license fee revenues recognized during the three and nine months ended September 30, 2006, as compared to one licensee during the three and nine months ended September 30, 2005, respectively. Three and two licensees represented approximately 82% and 95% of the Acacia Technologies group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.

Two and no customer(s) individually accounted for greater than 10% of the CombiMatrix group's product sales recognized during the three and nine months ended September 30, 2006, as compared to one and no customer(s) during the three and nine months ended September 30, 2005, respectively. Five and two customers represented approximately 89% and 84% of the CombiMatrix group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.

Stock-Based Compensation. Effective January 1, 2006, Acacia Research Corporation adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), which sets forth the accounting requirements for "share-based" compensation payments to employees and non-employee directors and requires that compensation cost relating to share-based payment transactions be recognized in the statement of operations. In March 2005, the SEC published Staff Accounting Bulletin No. 107 ("SAB 107"), which requires stock-based compensation to be classified in the same expense line items as cash compensation (i.e.

marketing, general and administrative and research and development expenses). The compensation cost for all stock-based awards is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award).

In addition, SFAS No. 123R requires stock-based compensation expense to be recorded only for those awards expected to vest using an estimated forfeiture rate. As such, SFAS No. 123R requires Acacia Research Corporation to estimate pre-vesting option forfeitures at the time of grant and reflect the impact of estimated pre-vesting option forfeitures on compensation expense recognized. Acacia Research Corporation considers several factors in connection with our estimates of pre-vesting forfeitures including types of awards, employee classification, and historical pre-vesting forfeiture data. Estimates of pre-vesting forfeitures must be periodically revised in subsequent periods if actual forfeitures differ from those estimates. To the extent that actual results differ from our estimates, such amounts will be recorded as cumulative adjustments in the period the estimates are revised. Prior to the adoption of SFAS No. 123R, Acacia Research Corporation accounted for forfeitures as they occurred under the pro forma disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation." All references to stock-based compensation expense in these notes, upon adoption of SFAS No. 123R, refers to stock-based compensation net of estimated forfeitures, as required by SFAS No. 123R.

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We adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation cost recognized for the nine months ended September 30, 2006 includes: (i) compensation cost for all stock-based awards granted prior to, but not yet vested as of January 1, 2006 (based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123 and previously presented in the pro forma footnote disclosures), and (ii) compensation cost for all stock-based awards granted subsequent to January 1, 2006 (based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123R). The cumulative effect of applying an estimated forfeiture percentage to stock-based payments granted prior to, but not yet vested as of, January 1, 2006 was not material.

Prior to January 1, 2006, Acacia Research Corporation accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and related interpretations. Acacia Research Corporation also followed the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), as amended by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Because Acacia Research Corporation previously adopted only the pro forma disclosure provisions of SFAS No. 123, we will recognize compensation cost relating to the unvested portion of awards granted prior to the date of adoption using the same estimate of the grant-date fair value and the same attribution method used to determine the pro forma disclosures under SFAS No. 123, except that forfeiture rates will be estimated for all awards, as required by SFAS No. 123R. In accordance with the requirements of the modified prospective transition method of adoption of SFAS No. 123R, the financial statement amounts for prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of recognizing compensation cost relating to stock-based awards.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the table below. Expected volatility is based on the separate historical volatility of the market prices of the AR-CombiMatrix stock and AR-Acacia Technologies stock. Volatilities of peer companies were also considered, when applicable, to address the lack of extensive historical volatility data for Acacia Research Corporation's classes of common stock. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term assumption was determined in accordance with guidance set forth in SAB 107, which provides a "simplified method" for estimating the expected term for stock options, granted prior to December 31, 2007, that 1) are granted at-the-money, 2) have exercisability conditioned only on completion of a service condition through the vesting date, 3) require that employees who terminate their service prior to vesting must forfeit the options, 4) provide that employees who terminate their service after vesting are granted limited time to exercise their stock options (typically 30-90 days), and 5) are nontransferable and nonhedgeable. The simplified method is based on the vesting period and the contractual term for each grant, or for each vesting-tranche for awards with graded vesting. The mid-point between the vesting commencement date and the expiration date is used as the expected term under this method. For awards with multiple vesting-tranches, the times from grant until these mid-points for each of the tranches were averaged to provide an overall expected term.

The fair value of restricted stock awards is determined by the product of the number of shares granted and the grant date market price of the AR-Acacia Technologies stock or AR-CombiMatrix stock.

The fair value of share-based awards is expensed on a straight-line basis over the requisite service period (generally the vesting period of the award), which is generally two to four years.

The fair value of stock options was estimated using the Black-Scholes option-pricing model based on the following weighted average assumptions:

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	Risk Free Interest Rate	Term	Volatility	Dividends
For the Three Months Ended September 30, 2006 ⁽¹⁾				
AR-CombiMatrix stock	5.10%	6 years	82%	0%
CMDX stock	5.00%	6.25 years		