
Consolidated Financial Statements and Supplementary Data

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Management's Report on Internal Control over Financial Reporting

Management of Cell Therapeutics, Inc., together with its consolidated subsidiaries (the Company), is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

As of the end of the Company's 2006 fiscal year, management conducted an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2006, is not effective.

Based on the COSO criteria, management has identified control deficiencies that represent material weaknesses. A material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Specifically, the following material weaknesses were identified.

In December 2006 we discovered material inadvertent errors in accounting for accounts payable and accrued expenses in our Italian subsidiary, Cell Therapeutics, Europe Srl (CTI Europe). As a result of the discovery of these errors, we restated our March 31, 2006, June 30, 2006 and September 30, 2006 interim consolidated financial statements filed in Forms 10-Q/A. In connection with the restatements, we reevaluated our disclosure controls and procedures and concluded that we had material weaknesses in internal controls over financial reporting as discussed in Item 9A.

Because of these material weaknesses, management concluded that we did not maintain effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria. The registered independent public accounting firm of Stonefield Josephson, Inc., as auditors of the Company's consolidated financial statements, has audited our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006, as stated in their report, which appears herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Cell Therapeutics, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Cell Therapeutics, Inc. did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weaknesses identified in management's assessment, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO). Cell Therapeutics, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment.

In December 2006, the Company discovered material inadvertent errors in accounting for accounts payable and accrued expenses related to their Italian subsidiary, Cell Therapeutics, Europe S.r.l., or CTI (Europe). As a result of the discovery of these errors, the Company restated its March 31, 2006, June 30, 2006 and September 30, 2006 interim condensed consolidated financial statements filed in Forms 10-Q/A. In connection with the restatements, the Company determined that it had the following material weaknesses:

- The Company did not maintain an effective review and approval process in CTI (Europe) to ensure the accuracy of accounts payable and accrued expenses for certain activities shared by headquarters and CTI (Europe) in conformity with generally accepted accounting principles.
- The Company did not maintain effective internal controls related to the financial reporting process to detect errors that are not identified by the process level controls in CTI (Europe).

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2006 consolidated financial statements, and this report does not affect our report dated March 16, 2007 on those consolidated financial statements.

In our opinion, management's assessment that Cell Therapeutics, Inc. did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, Cell Therapeutics, Inc. has not maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Cell Therapeutics, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity (deficit) and other comprehensive loss, and cash flows for the years ended December 31, 2006 and 2005 and our report dated March 16, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ Stonefield Josephson, Inc.

Stonefield Josephson, Inc.

Los Angeles, CA

March 16, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Cell Therapeutics, Inc.

We have audited the accompanying consolidated balance sheets of Cell Therapeutics, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' deficit and other comprehensive loss, and cash flows for the years ended December 31, 2006 and 2005. Our audits also included the consolidated financial statement schedule listed in the index at Item 15(a)(ii) as of and for the years ended December 31, 2006 and 2005. These consolidated financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cell Therapeutics, Inc. as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years ended December 31, 2006 and 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related consolidated financial statement schedule as of and for the years ended December 31, 2006 and 2005, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 13 to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payments.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Cell Therapeutics, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 16, 2007 expressed a unqualified opinion on management's assessment of, and an adverse opinion on the effectiveness of internal control over financial reporting.

/s/ Stonefield Josephson, Inc.

Stonefield Josephson, Inc.

Los Angeles, Ca

March 16, 2007

**REPORT OF GRANT THORNTON LLP,
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders

Cell Therapeutics, Inc.

We have audited the accompanying consolidated balance sheet of Cell Therapeutics, Inc. as of December 31, 2004, and the related consolidated statements of operations, shareholders' deficit, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Cell Therapeutics, Inc. as of December 31, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The financial statement schedule listed in the index at Item 15(a) is presented for purposes of additional analysis and is not a required part of the 2004 basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ GRANT THORNTON LLP

Seattle, WA

February 28, 2005

CELL THERAPEUTICS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	<u>December 31,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,129	\$ 50,022
Restricted cash	—	25,596
Securities available-for-sale	36,708	18,858
Interest receivable	570	187
Accounts receivable, net	183	2,306
Prepaid expenses and other current assets	9,948	10,107
Total current assets	<u>64,538</u>	<u>107,076</u>
Property and equipment, net	7,915	12,278
Goodwill	17,064	17,064
Other intangibles, net	1,663	2,239
Other assets	10,641	16,783
Total assets	<u>\$ 101,821</u>	<u>\$ 155,440</u>
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 639	\$ 3,370
Accrued expenses	28,567	17,558
Current portion of deferred revenue	80	80
Current portion of long-term obligations	2,816	2,880
Current portion of derivative liability	2,270	—
Current portion of convertible senior notes	—	6,900
Total current liabilities	<u>34,372</u>	<u>30,788</u>
Deferred revenue, less current portion	478	558
Long-term obligations, less current portion	4,667	7,326
7.5% convertible senior notes (including fair value of derivative liability of \$1,300)	45,916	—
6.75% convertible senior notes	6,945	72,146
Convertible senior subordinated notes	82,557	122,079
Convertible subordinated notes	28,490	29,640
Commitments and contingencies		
Shareholders' deficit:		
Preferred stock, no par value:		
Authorized shares—10,000,000		
Series C, 100,000 shares designated, none issued or outstanding	—	—
Common stock, no par value:		
Authorized shares—200,000,000		
Issued and outstanding shares—145,588,923 and 73,421,721 at December 31, 2006 and 2005, respectively	860,691	721,544
Deferred stock-based compensation	—	(1,669)
Accumulated other comprehensive loss	(1,187)	(1,683)
Accumulated deficit	(961,108)	(825,289)
Total shareholders' deficit	<u>(101,604)</u>	<u>(107,097)</u>
Total liabilities and shareholders' deficit	<u>\$ 101,821</u>	<u>\$ 155,440</u>

See accompanying notes.

CELL THERAPEUTICS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Year Ended December 31,		
	2006	2005	2004
Revenues:			
Product sales	\$ —	\$ 14,599	\$ 26,626
License and contract revenue	80	1,493	2,968
Total revenues	<u>80</u>	<u>16,092</u>	<u>29,594</u>
Operating expenses:			
Cost of product sold	—	518	1,104
Research and development	61,994	68,767	101,127
Selling, general and administrative	35,303	61,717	78,522
Acquired in-process research and development	—	—	87,375
Amortization of purchased intangibles	792	1,254	2,294
Restructuring charges and related asset impairments	591	12,780	—
Gain on divestiture of TRISENOX	—	(71,211)	—
Total operating expenses	<u>98,680</u>	<u>73,825</u>	<u>270,422</u>
Loss from operations	(98,600)	(57,733)	(240,828)
Other income (expense):			
Investment and other income, net	2,866	2,588	1,636
Interest expense	(19,829)	(16,546)	(10,988)
Foreign exchange gain (loss)	1,877	8	(2,118)
Make-whole interest expense	(24,753)	(1,013)	—
Debt conversion expense	—	(23,608)	—
Gain on derivative liabilities	6,024	236	—
Gain on exchange of convertible notes	7,978	—	—
Settlement expense	(11,382)	—	—
Loss on extinguishment of royalty obligation	—	(6,437)	—
Other expense, net	<u>(37,219)</u>	<u>(44,772)</u>	<u>(11,470)</u>
Net loss	<u>\$ (135,819)</u>	<u>\$ (102,505)</u>	<u>\$ (252,298)</u>
Basic and diluted net loss per share	<u>\$ (1.21)</u>	<u>\$ (1.59)</u>	<u>\$ (4.67)</u>
Shares used in calculation of basic and diluted net loss per share	<u>112,283</u>	<u>64,553</u>	<u>54,052</u>

See accompanying notes.

CELL THERAPEUTICS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' DEFICIT AND OTHER COMPREHENSIVE LOSS

(In thousands)

	Common Stock		Deferred Stock-based	Accumulated Deficit	Accumulated Other	Total
	Shares	Amount	Compensatio n		Comprehensiv e Income/(Loss)	
-34						
-434						
Balance at December 31, 2003	34,339	394,750	(5,956)	(470,486)	(850)	(82,542)
Issuance of common stock for the acquisition of Novuspharma	15,629	189,760	—	—	—	189,760
Conversion of warrants to common stock	22	—	—	—	—	—
Proceeds from issuance of common stock, net	12,936	63,846	—	—	—	63,846
Proceeds from stock options exercised and stock sold via employee stock purchase plan	595	2,220	—	—	—	2,220
Deferred compensation	315	990	(990)	—	—	—
Amortization of deferred compensation of restricted stock	—	—	4,210	—	—	4,210
Equity-based compensation expense	27	1,207	—	—	—	1,207
Comprehensive loss:						
Foreign currency translation gain	—	—	—	—	2,511	2,511
Unrealized gains on securities available-for-sale	—	—	—	—	4	4
Unrealized gains on interest rate swap	—	—	—	—	374	374
Net loss for the year ended December 31, 2004	—	—	—	(252,298)	—	(252,298)
Comprehensive loss						(249,409)
Balance at December 31, 2004	63,863	652,773	(2,736)	(722,784)	2,039	(70,708)
Conversion of convertible senior subordinated notes to common stock	3,323	39,047	—	—	—	39,047
Equity instruments issued to induce conversion of convertible senior subordinated notes to common stock	3,378	23,608	—	—	—	23,608
Issuance of warrants to underwriter of convertible senior notes	—	564	—	—	—	564
Conversion of 6.75% convertible senior notes to common stock	1,141	3,000	—	—	—	3,000
Proceeds from stock options exercised and stock sold via employee stock purchase plan	81	238	—	—	—	238
Deferred compensation	1,641	2,186	(2,186)	—	—	—
Amortization of deferred compensation of restricted stock	—	—	3,253	—	—	3,253
Equity-based compensation expense	(5)	(49)	—	—	—	(49)
Conversion of restricted share rights to common stock	—	177	—	—	—	177
Comprehensive loss:						
Foreign currency translation loss	—	—	—	—	(4,174)	(4,174)
Unrealized gains on securities available-for-sale	—	—	—	—	16	16
Unrealized gains on interest rate swap	—	—	—	—	436	436
Net loss for the year ended December 31, 2005	—	—	—	(102,505)	—	(102,505)
Comprehensive loss						(106,227)
Balance at December 31, 2005	73,422	721,544	(1,669)	(825,289)	(1,683)	(107,097)
Conversion of 6.75% convertible senior notes to common stock	26,377	69,345	—	—	—	69,345
Proceeds from issuance of common stock, net	23,121	37,764	—	—	—	37,764
Repurchase of common stock and warrants	(1,094)	(3,025)	—	—	—	(3,025)
Conversion of 7.5% convertible senior notes to common stock	8,403	17,560	—	—	—	17,560
Exercise of warrants to common stock	6,595	164	—	—	—	164
Proceeds from issuance of common stock to Novartis, net	8,671	14,837	—	—	—	14,837
Conversion of convertible senior subordinated notes to common stock	—	4	—	—	—	4
Proceeds from stock sold via employee stock purchase plan	15	17	—	—	—	17
Deferred compensation	(9)	(1,669)	1,669	—	—	—
Equity-based compensation expense	—	4,150	—	—	—	4,150
Conversion of restricted share rights to common stock	88	—	—	—	—	—
Comprehensive loss:						
Foreign currency translation gain	—	—	—	—	419	419
Realized loss on liquidation of foreign subsidiary	—	—	—	—	41	41
Unrealized gains on securities available-for-sale	—	—	—	—	36	36
Net loss for the year ended December 31, 2006	—	—	—	(135,819)	—	(135,819)
Comprehensive loss						(135,323)
Balance at December 31, 2006	145,589	\$ 860,691	\$ —	\$ (961,108)	\$ (1,187)	\$ (101,604)

See accompanying notes.

CELL THERAPEUTICS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2006	2005	2004
Operating activities			
Net loss	\$ (135,819)	\$ (102,505)	\$ (252,298)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	6,430	9,975	10,311
Acquired in-process research and development	—	—	87,375
Equity-based compensation expense	4,150	3,381	5,417
Loss on disposition of property and equipment	63	157	505
Amortization of investment premium	74	303	1,123
Non-cash gain on exchange of convertible notes	(7,978)	—	—
Non-cash gain on derivative liabilities	(6,024)	(236)	—
Non-cash interest expense	10,977	2,930	1,091
Non-cash loss on liquidation of subsidiary	41	—	—
Asset impairments	—	3,020	—
Debt conversion expense	—	23,608	—
Gain on divestiture of TRISENOX	—	(71,211)	—
Loss on extinguishment of royalty obligation	—	6,437	—
Non-cash rent (benefit) expense	(15)	180	415
Loss on sale of investment securities	(1)	14	29
Changes in operating assets and liabilities:			
Restricted cash	1,054	(1,045)	—
Interest receivable	(383)	(40)	1,109
Accounts receivable, net	1,700	(894)	(221)
Inventory	—	4	88
Prepaid expenses and other current assets	583	1,971	(1,068)
Other assets	2,907	(1,452)	2,734
Accounts payable	(2,925)	(3,451)	(1,651)
Accrued expenses	11,476	(5,181)	(2,292)
Deferred revenue	(80)	(1,081)	(819)
Excess facilities obligations	(2,383)	6,334	—
Other long-term obligations	(453)	3,550	—
Total adjustments	19,213	(22,727)	104,146
Net cash used in operating activities	(116,606)	(125,232)	(148,152)
Investing activities			
Net proceeds from divestiture of TRISENOX	—	70,417	—
Purchases of securities available-for-sale	(68,905)	(46,827)	(59,011)
Proceeds from maturities of securities available-for-sale	14,665	22,693	79,333
Proceeds from sales of securities available-for-sale	36,353	15,815	50,830
Purchases of property and equipment	(534)	(2,016)	(4,632)
Proceeds from sale of property and equipment	539	253	—
Additional consideration related to PolaRx acquisition	—	—	(4,969)
Repayment of notes receivable from officers	—	—	3,500
Net cash acquired in the Novuspharma merger	—	—	89,391
Net cash provided by (used in) investing activities	(17,882)	60,335	154,442

See accompanying notes.

CELL THERAPEUTICS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)

(In thousands)

	Year Ended December 31,		
	2006	2005	2004
Financing activities			
Proceeds from issuance of common stock, net	37,764	—	63,846
Repurchase of common stock and warrants	(3,025)	—	—
Proceeds from issuance of 7.5% convertible senior notes, net	31,174	—	—
Proceeds from issuance of common stock to Novartis, net	14,837	—	—
Proceeds from issuance of 6.75% convertible senior notes, net	—	77,704	—
Restricted cash from issuance of 6.75% convertible senior notes, net	—	(24,600)	—
Release of restricted cash related to 6.75% convertible senior notes	24,600	—	—
Mandatory redemptions of 6.75% convertible senior notes	(2,655)	—	—
Proceeds from common stock warrants exercised	164	—	—
Proceeds from royalty based financing	—	—	25,000
Repayment of royalty obligation	—	(39,388)	—
Proceeds from common stock options exercised and stock sold via the employee stock purchase plan	17	238	2,220
Repayment of long-term obligations	(138)	(1,805)	(2,172)
Net cash provided by financing activities	102,738	12,149	88,894
Effect of exchange rate changes on cash and cash equivalents	(1,143)	(2,263)	1,411
Net increase (decrease) in cash and cash equivalents	(32,893)	(55,011)	96,595
Cash and cash equivalents at beginning of period	50,022	105,033	8,438
Cash and cash equivalents at end of period	<u>\$ 17,129</u>	<u>\$ 50,022</u>	<u>\$ 105,033</u>
Supplemental disclosure of cash flow information			
Cash paid during the period for interest	<u>\$ 34,177</u>	<u>\$ 12,640</u>	<u>\$ 9,823</u>
Cash paid for taxes	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Supplemental disclosure of noncash financing and investing activities			
Conversion of 6.75% convertible senior notes to common stock	<u>\$ 69,345</u>	<u>\$ 3,000</u>	<u>\$ —</u>
Conversion of 7.5% convertible senior notes to common stock	<u>\$ 17,560</u>	<u>\$ —</u>	<u>\$ —</u>
Conversion of convertible senior subordinated notes to common stock, including accrued interest	<u>\$ 4</u>	<u>\$ 39,047</u>	<u>\$ —</u>
Issuance of warrants to underwriter of convertible senior notes	<u>\$ —</u>	<u>\$ 564</u>	<u>\$ —</u>
Extinguishment of 5.75% convertible senior subordinated notes in exchange for 7.5% convertible senior notes	<u>\$ 39,518</u>	<u>\$ —</u>	<u>\$ —</u>
Extinguishment of 5.75% convertible subordinated notes in exchange for 7.5% convertible senior notes	<u>\$ 1,150</u>	<u>\$ —</u>	<u>\$ —</u>
Issuance of 7.5% convertible senior notes in exchange for 5.75% subordinated and senior subordinated notes	<u>\$ 33,156</u>	<u>\$ —</u>	<u>\$ —</u>
Common stock issued for acquisition of Novuspharma	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 189,760</u>

See accompanying notes.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Cell Therapeutics, Inc., or CTI or the Company, focuses on the development, acquisition and commercialization of drugs for the treatment of cancer. Our principal business strategy is to focus our activities on cancer therapeutics, an area that represents a large market opportunity that is not adequately served by existing therapies. Our operations are primarily conducted in the United States and Italy.

We operate in a highly regulated and competitive environment. The manufacturing and marketing of pharmaceutical products require approval from, and are subject to, ongoing oversight by the Food and Drug Administration, or FDA, in the United States, by the European Agency for Evaluation of Medicinal Products, or EMEA, in Europe and by comparable agencies in other countries. Obtaining approval for a new therapeutic product is never certain and may take many years and involve expenditure of substantial resources.

Principles of Consolidation

The consolidated financial statements include the accounts of Cell Therapeutics, Inc. and its wholly owned subsidiaries which include Cell Therapeutics Europe S.r.l., CTI Technologies, Inc., CTI Corporate Development, Inc., and Cell Therapeutics (Ireland) Holding Limited, which was liquidated in the fourth quarter of 2006. The Company's wholly owned subsidiaries, Cell Therapeutics (UK) Limited and PolaRx Biopharmaceuticals, Inc., or PolaRx, were sold to Cephalon in connection with the divestiture of TRISENOX in July 2005 and the Company's majority owned subsidiary, PanGenex, Inc., was dissolved in 2004. All intercompany transactions and balances are eliminated in consolidation.

Liquidity

Cash and cash equivalents, securities available-for-sale and interest receivable are approximately \$54.4 million as of December 31, 2006. In addition, in February 2007, we closed a Series A 3% convertible preferred stock and common stock warrant financing generating proceeds of approximately \$18.8 million, net of placement agency fees. We expect that this amount will not be sufficient to fund our operations for the next twelve months. Accordingly, we will need to raise additional funds and are currently exploring alternative sources of equity or debt financing. Prior to issuance of additional equity of other convertible instruments, we need to increase our authorized shares and we are currently seeking shareholder approval to do so. We have a Step-Up Equity Financing Agreement with Société Générale which we may be able to utilize to provide additional equity funding (see Note 9, *Equity Financing Agreement*). However, additional funding may not be available on favorable terms or at all. If we are unable to raise additional capital in the near term, we have developed a plan to further curtail operations significantly, by delaying, modifying, or canceling selected aspects of research and development programs related to XYOTAX, pixantrone and other products we may be developing. The plan contains reductions in operating expenditures related to certain research and development and general and administrative activities including compensation and benefits, corporate costs and clinical trial costs, which are designed to allow the company to continue to operate on a going concern basis.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. For example, estimates included assumptions used in calculating stock compensation expense, our liability for excess facilities, the useful lives of fixed assets, the fair value of our derivatives, calculating our tax provision and related valuation allowance,

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

determining potential impairment of goodwill and other intangible assets, and prior to the divestiture of TRISENOX to Cephalon our sales return reserve, inventory obsolescence reserve, and our estimate of royalty and interest payments in connection with our royalty obligation. Actual results could differ from those estimates.

Cash and Cash Equivalents

We consider all highly liquid debt instruments with maturities of three months or less at the time acquired to be cash equivalents. Cash equivalents represent short-term investments consisting of investment-grade corporate and government obligations, carried at cost, which approximates market value.

Restricted Cash

As of December 31, 2005 restricted cash included \$24.6 million held in escrow to fund potential redemptions of up to 30% of our 6.75% convertible senior notes on April 30, 2006 (see Note 6, *Long-Term Obligations*) as well as restricted cash of \$1.0 million held in connection with the liquidation of Cell Therapeutics (Ireland) Holding Limited.

Securities Available-for-Sale

We determine the appropriate classification of debt securities at the time of purchase. We currently classify our investment portfolio as available-for-sale which consists of U.S. government and corporate obligations with maturities of up to one year and carries the securities at fair value based on quoted market prices with unrealized gains and losses included in accumulated other comprehensive loss. The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Interest on securities available-for-sale and amortization and accretion of premiums and discounts are included in investment income. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities, if any, are included in investment income. The cost of securities sold is based on the specific identification method.

Certain Concentrations

We are exposed to risks associated with foreign currency transactions to use U.S. dollars to make contract payments denominated in euros or vice versa. As the net positions of our unhedged foreign currency transactions fluctuate, our earnings might be negatively affected. In addition, we are exposed to risks associated with the translation of euro-denominated financial results and amounts into U.S. dollars. We currently do not utilize forward exchange contracts or any type of hedging instruments to hedge foreign exchange risk as we believe our overall exposure is relatively limited.

We are subject to concentration of credit risk primarily from our cash investments. Under our investment guidelines, credit risk is managed by diversification of the investment portfolio and by the purchase of investment-grade securities. Prior to the divestiture of TRISENOX, we did not require collateral or other security to support credit sales, but provided an allowance for bad debts when warranted.

If we are unable to obtain sufficient quantities of needed starting materials for the manufacture of our products in development from existing suppliers, or if we were unable to source these materials and services from other suppliers and manufacturers, certain research and development and sales activities may be delayed.

We are exposed to certain labor risks related to our European employees, who represent approximately 35% of our total employees as of December 31, 2006, and who are subject to a collective bargaining agreement as well as to local regulations governing employment.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Product Sales

Because we sold our only commercial product, TRISENOX, to Cephalon on July 18, 2005, there have been no product sales subsequent to this date. Prior to this, we recognized revenue from product sales when there was persuasive evidence that an arrangement existed, title had passed and delivery had occurred, the price was fixed and determinable, and collectability was reasonably assured. Product sales were generally recorded upon shipment net of an allowance for returns and discounts. Customers were able to return damaged or expired inventory for up to one year after the expiration date. Estimated returns were based on historical returns and sales patterns. If we were unable to reasonably estimate returns related to a particular customer or market, we deferred revenue recognition until such rights had expired. Allowances for returns, discounts and bad debts were netted against accounts receivable. There was no allowance for returns, discount and bad debts at December 31, 2006 and 2005 as all trade receivables were sold in connection with the divestiture of TRISENOX to Cephalon.

During 2004, we recorded a \$1.3 million adjustment to decrease our sales reserve to reflect a lower than expected estimated weighted average return rate for our remaining open production batches and a lower than expected actual return rate on our most recently closed production batches.

License and Contract Revenues

We may generate revenue from technology licenses, collaborative research and development arrangements, cost reimbursement contracts and research grants. Revenue under technology licenses and collaborative agreements typically consists of nonrefundable and/or guaranteed technology license fees, collaborative research funding, and various milestone and future product royalty or profit-sharing payments.

Revenue associated with up-front license fees and research and development funding payments under collaborative agreements is recognized ratably over the relevant periods specified in the agreement, generally the research and development period. If the time period is not defined in the agreement, we calculate the revenue recognition period based on our current estimate of the research and development period considering experience with similar projects, level of effort and the stage of development. Should there be a change in our estimate of the research and development period, we will revise the term over which the initial payment is recognized. Revenue from substantive at-risk milestones and future product royalties is recognized as earned based on the completion of the milestones and product sales, as defined in the respective agreements. Revenue under cost reimbursement contracts and research grants is recognized as the related costs are incurred. Payments received in advance of recognition as revenue are recorded as deferred revenue.

We evaluate multiple element arrangements pursuant to Emerging Issues Task Force, or EITF, 00-21, *Revenue Arrangements with Multiple Deliverables* for multiple element arrangements that have continuing performance obligations, we recognize contract, milestone or license fees together with any up-front payments over the term of the arrangement as we complete our performance obligation, unless the delivered technology has stand alone value to the customer and there is objective, reliable evidence of fair value of the undelivered element in the arrangement. Additionally, pursuant to the guidance of Securities and Exchange Commission Staff Accounting Bulletin 104, or SAB 104, unless evidence suggests otherwise, revenue from consideration received is recognized on a straight-line basis over the expected term of the arrangement.

Cost of Product Sold

As we sold our only commercial product, TRISENOX, to Cephalon on July 18, 2005, there is no cost of product sold subsequent to this date. Cost of product sold consisted of the cost of TRISENOX sold to our customers, including allowances for excess inventory that may expire and become unsaleable. Royalties paid on product sales, as well as shipping and handling costs were also included in cost of product sold.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Accounts Receivable

Due to the sale of TRISENOX to Cephalon in July, 2005, our accounts receivable balance does not include any trade receivables related to TRISENOX as of December 31, 2006 and 2005. The balance as of December 31, 2005 consists primarily of receivables from Cephalon for transition services provided as well as receivables from fixed asset sales.

Research and Development Expenses

Research and development expenses include related salaries and benefits, clinical trial and related manufacturing costs, contract and other outside service fees, and facilities and overhead costs related to our research and development efforts. Research and development expenses also consist of costs incurred for proprietary and collaboration research and development and include activities such as product registries and investigator-sponsored trials. Research and development costs are expensed as incurred. Generally, in instances where we enter into agreements with third parties for research and development activities, costs are expensed upon the earlier of when non-refundable amounts are due or as services are performed unless there is an alternative future use of the funds in other research and development projects. Amounts due under such arrangements may be either fixed fee or fee for service, and may include upfront payments, monthly payments, and payments upon the completion of milestones or receipt of deliverables.

Acquired in-process research and development

Costs to acquire in-process research and development, or IPRD, projects and technologies which had no alternative future use and which had not reached technological feasibility as of January 1, 2004, the date of our merger with Novuspharma, were expensed as incurred.

Value Added Tax Receivable

Our European subsidiaries are subject to Value Added Tax, or VAT, which is usually applied to all goods and services purchased and sold throughout Europe. The VAT receivable is approximately \$10.6 million and \$8.9 million as of December 31, 2006 and December 31, 2005, respectively, of which \$5.5 million and \$8.3 million is included in *other assets* and \$5.1 million and \$0.6 million is included in *prepaid expenses and other current assets* as of December 31, 2006 and December 31, 2005, respectively. This receivable balance relates to our Italian operations and typically has a three year collection period. We review our VAT receivable balance for impairment whenever events or changes in circumstances indicate the carrying amount might not be recoverable.

Property and Equipment

Property and equipment are carried at cost, less accumulated depreciation and amortization. Leasehold improvements are amortized over the lesser of the useful life or the term of the applicable lease using the straight-line method. Depreciation commences at the time assets are placed in service and is calculated using the straight-line method over the estimated useful lives of the assets ranging from three to five years.

Impairment of Long-lived Assets

We review our long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted future cash flows to the recorded value of the asset. If an impairment is indicated, the asset is written down to its estimated fair value based on quoted fair market values. During 2005 we recorded a charge of approximately \$1.0 million for asset impairments associated with our restructuring activities (see Note 10, *Restructuring Activities*).

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Goodwill and Other Intangible Assets

Goodwill is not amortized but is tested for impairment at least annually, or more frequently if indicators of impairment are present. If goodwill is impaired it is written down; however, no impairment of goodwill has been found to date.

There were no changes in the net carrying amount of goodwill during the years ended December 31, 2006, 2005 and 2004.

Other intangible assets consist of acquisition-related intangible assets. These other intangible assets have finite lives and are carried at cost less accumulated amortization. Amortization is computed using the straight-line method over the estimated useful lives of the respective assets, which is approximately five years.

Other intangible assets are composed of the following as of December 31 (in thousands):

	2006		
	Gross Carryin	Accumulated Amortization	Net Carrying Amount
Assembled workforce	\$ 5,088	\$ (3,425)	\$ 1,663
	2005		
	Gross Carryin	Accumulated Amortization	Net Carrying Amount
Assembled workforce	\$ 4,566	\$ (2,327)	\$ 2,239

The change in the value of other intangible assets is as follows:

	Patents and Other Intangibles	Assembled Workforce
Balance as of January 1, 2004	\$ 1,335	\$ —
Increase due to acquisition of Novuspharma	—	4,868
Amortization	(1,335)	(959)
Increase due to exchange rate	—	266
Balance as of December 31, 2004	—	4,175
Impairment	—	(232)
Amortization	—	(1,254)
Decrease due to exchange rate	—	(450)
Balance as of December 31, 2005	—	2,239
Amortization	—	(792)
Increase due to exchange rate	—	216
Balance as of December 31, 2006	\$ —	\$ 1,663

In 2004 we recorded an intangible asset related to the assembled workforce acquired in our acquisition of Novuspharma. In 2005, *restructuring charges and related asset impairments* includes an impairment charge of \$0.2 million due to the termination of certain Italian employees included in the original valuation of this asset. We expect amortization expense on assembled workforce to be approximately \$0.8 million for each of the next two years, at which time it will be fully amortized.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Royalty Obligation

Our royalty obligation to PharmaBio Development, or PharmaBio, was recorded as debt as we had significant continuing involvement in the generation of cash flows due to PharmaBio. The obligation was accreted using the effective interest method and an imputed interest rate that was based on our estimates of total royalty and interest payments due under the arrangement. The amount of royalty and interest payments varied depending on whether we reached certain TRISENOX targets and certain other factors as described in the agreement. We reassessed the imputed interest rate as circumstances changed. We extinguished the royalty obligation in July 2005.

Stock-Based Compensation

On January 1, 2006, we adopted Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 123(R), *Share-Based Payment (Revised 2004)*, or SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. Prior to January 1, 2006, we accounted for share-based payments under the recognition and measurement provisions of Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25, and related interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123. In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. Under our plan, stock options are generally granted at fair market value.

We adopted SFAS 123(R) using the modified-prospective transition method. Under this transition method, beginning on the effective date, or January 1, 2006, compensation cost recognized includes (1) compensation cost for all share-based payments 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 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In addition, in accordance with the modified-prospective transition method, results for prior periods have not been restated to reflect the impact of SFAS 123(R). We use the straight-line single-option method to recognize the value of stock-based compensation expense for all share-based payment awards granted after January 1, 2006. Expense is recognized using the graded-vesting multiple-option method for options granted prior to January 1, 2006.

Under SFAS 123(R), stock-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Based on this, our stock-based compensation is reduced for estimated forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123(R) and the Emerging Issues Task Force, or EITF, consensus in Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is periodically remeasured as the underlying options vest.

Advertising Costs

The costs of advertising are expensed as incurred. We incurred advertising costs of \$0.4 million, \$1.8 million and \$1.8 million in 2006, 2005, and 2004 respectively.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Net Loss per Share

Basic net loss per share is calculated based on the net loss divided by the weighted average number of shares outstanding for the period excluding any dilutive effects of options, warrants, unvested restricted stock awards and convertible securities. Diluted earnings per share assumes the conversion of all dilutive convertible securities, such as convertible subordinated debt using the if-converted method, and assumes the exercise or vesting of other dilutive securities, such as options, warrants and restricted stock using the treasury stock method.

Derivatives Embedded in Certain Debt Securities

We evaluate financial instruments for freestanding or embedded derivatives in accordance with SFAS, No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or SFAS 133, and related guidance. Derivative instruments are recorded at fair value with changes in value recognized in the period of change.

Our 6.75% convertible senior notes, or 6.75% notes, and our 7.5% convertible senior notes, or 7.5% notes, contain certain features providing for payments in cash or common stock to be made in the event of certain conversions or repurchases of the debt. In the event of any conversion of our 6.75% notes to common stock, the feature calls for make-whole payments equal to the interest on the debt over its term less any amounts paid prior to the date of the conversion. Our 7.5% notes include a feature that calls for make-whole payments in the event of automatic conversion or if the holder requires us to repurchase the notes upon certain non-stock changes in control. This payment is equal to \$225 per \$1,000 principal amount of the notes less any interest amounts paid prior to the date of conversion or repurchase.

These make-whole features represent embedded derivatives which are required to be accounted for separately from the related debt securities. The fair value of the derivative for the 6.75% notes is calculated based on a discounted cash flow model. The fair value of the derivative related to the 7.5% notes is calculated using a Monte Carlo simulation model that incorporates factors such as the current price of our common stock, its volatility, and time to expiration of the make-whole feature. As of December 31, 2006 we determined that we would make additional discretionary make-whole payments to certain investors in 2007. These additional payments constitute modifications to the terms of the agreement and have been included in the valuation model. The value of these payments as of December 31, 2006 are recorded in *current portion of derivative liability*. Changes in the estimated fair value of the liabilities are included in *gain on derivative liabilities* and will be calculated until the relevant feature expires or all of the relevant notes are converted or repurchased.

Other Financial Instruments

At December 31, 2006 and 2005, the carrying value of financial instruments such as receivables and payables approximated their fair values based on the short-term maturities of these instruments. The carrying value of other long-term liabilities approximated fair values because the underlying interest rates approximate market rates at the balance sheet dates.

Based on their respective trading prices, the fair values of our convertible senior notes, convertible senior subordinated notes and convertible subordinated notes are as follows as of December 31 (in thousands):

	2006	2005
7.5% convertible senior notes	\$ 42,780	\$ —
4.0% convertible senior subordinated notes	\$ 34,193	\$ 25,369
5.75% convertible senior subordinated notes	\$ 20,555	\$ 43,504
5.75% convertible subordinated notes	\$ 19,373	\$ 14,524
6.75% convertible senior notes	\$ 6,549	\$ 79,000

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Foreign Currency Translation

For our operations that have a functional currency other than the U.S. dollar, gains and losses resulting from the translation of the functional currency into U.S. dollars for financial statement presentation are not included in determining net loss but are accumulated in the cumulative foreign currency translation adjustment account as a separate component of shareholders' deficit in accordance with SFAS 52, *Foreign Currency Translation*. We had a gain from foreign currency translation of \$0.4 million and \$2.5 million for the years ended December 31, 2006 and 2004, respectively and a loss from foreign currency translation of \$4.2 million for the year ended December 31, 2005.

Comprehensive Loss

Comprehensive loss is comprised of net loss and other comprehensive income or loss. SFAS 130, *Reporting Comprehensive Income*, provides for unrealized gains and losses on our securities available-for-sale and net exchange gains or losses resulting from the translation of assets and liabilities of foreign subsidiaries to be included in other comprehensive income or loss. Total comprehensive loss was \$135.3 million, \$106.2 million and \$249.4 million as of December 31, 2006, 2005 and 2004, respectively.

Information regarding the components of accumulated other comprehensive loss is as follows (in thousands):

	<u>2006</u>	<u>2005</u>
Foreign currency translation adjustment	\$ (1,203)	\$ (1,663)
Net unrealized gain (loss) on securities available-for-sale	16	(20)
Total other accumulated comprehensive loss	<u>\$ (1,187)</u>	<u>\$ (1,683)</u>

Recently Issued Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation Number, or FIN, 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, or FIN 48, which clarifies the accounting for uncertainty in tax positions. This interpretation will require that we recognize the effect of a tax position in our financial statements, if there is a greater likelihood than not of the position being sustained upon audit, based on the technical merits of the position. The provisions of FIN 48 are effective beginning January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to the opening balance of deficit. We are currently evaluating the impact of implementation on our consolidated financial statements, however we do not believe that the adoption of FIN 48 will have a material impact on our result of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157, which provides guidance on how to measure assets and liabilities that use fair value. This statement clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 will apply whenever another generally accepted accounting principle requires, or permits, assets or liabilities to be measure at fair value but does not expand the use of fair value to any new circumstances. This statement will also require additional disclosures in both annual and quarterly reports. SFAS 157 is effective for fiscal years beginning after November 2007, and will be adopted by us beginning January 1, 2008. We are currently evaluating the potential impact this statement may have on our financial statements, but do not believe the impact of adoption will be material.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In September 2006, the SEC staff issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, or SAB 108. SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of determining whether the current year's financial statements are materially misstated. SAB 108 is effective for fiscal years ending after November 15, 2006. We will initially apply the provisions of SAB 108 in connection with the preparation of our annual financial statements for the year ending December 31, 2006. The adoption of SAB 108 did not have a material impact on our results of operations and financial position.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, or SFAS 158. This Statement requires companies to recognize in their statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status and to measure a plan's assets and its obligations that determine its funded status as of the end of the company's fiscal year. Additionally, SFAS 158 requires companies to recognize changes in the funded status of a defined benefit postretirement plan in the year that the changes occur and those changes will be reported in comprehensive income. The provisions of SFAS 158 are effective as of the end of fiscal year 2006 and the adoption of SFAS 158 did not have a material impact on our results of operations and financial position.

In December 2006, the FASB issued FASB Staff Position, or FSP, EITF 00-19-2, or FSP EITF 00-19-2, *Accounting for Registration Payment Arrangements*. FSP EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with SFAS 5, *Accounting for Contingencies* and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. FSP EITF 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of FSP EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006. Early adoption of FSP EITF 00-19-2 is permitted, and we have elected such early adoption.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115*, or SFAS 159. The Statement permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value that are not currently measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes presentation and disclosure requirements in order to facilitate comparisons between entities choosing different measurement attributes for similar types of assets and liabilities. SFAS 159 does not affect existing accounting requirements for certain assets and liabilities to be carried at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the requirements of SFAS 159 and have not yet determined the impact on the financial statements.

Reclassifications

Certain prior year items have been reclassified to conform to current year presentation.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. Securities Available-for-Sale

Securities available-for-sale consist of the following debt securities as of December 31 (in thousands):

	2006			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value
Corporate obligations	\$ 30,422	\$ 23	\$ (8)	\$ 30,437
U.S. government obligations	6,270	2	(1)	6,271
	<u>\$ 36,692</u>	<u>\$ 25</u>	<u>\$ (9)</u>	<u>\$ 36,708</u>
	2005			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value
Corporate obligations	\$ 16,525	\$ —	\$ (18)	\$ 16,507
U.S. government obligations	2,353	—	(2)	2,351
	<u>\$ 18,878</u>	<u>\$ —</u>	<u>\$ (20)</u>	<u>\$ 18,858</u>

As of December 31, 2006, and 2005, all securities available-for-sale had contractual maturities of less than one year. Gross realized gains and losses to date have not been material.

3. Property and Equipment

Property and equipment are composed of the following as of December 31 (in thousands):

	2006	2005
Leasehold improvements	\$ 11,208	\$ 12,694
Lab equipment	6,311	5,483
Furniture and office equipment	17,878	17,122
	35,397	35,299
Less: accumulated depreciation and amortization	(27,482)	(23,021)
	<u>\$ 7,915</u>	<u>\$ 12,278</u>

Depreciation expense of \$5.6 million, \$8.9 million and \$8.0 million was recognized during 2006, 2005, and 2004, respectively. We also recorded fixed asset impairments of \$0.8 million during 2005 related to our restructuring activities.

4. Accrued Liabilities

Accrued liabilities consist of the following as of December 31 (in thousands):

	2006	2005
USAO litigation claim (see note 20, <i>Legal Proceedings</i>)	\$ 10,500	\$ —
Clinical development and regulatory expense	8,855	3,616
Employee compensation and related expenses	4,261	6,566
Manufacturing expense	1,286	1,387
Insurance financing and accrued interest expense	917	2,391
Corporate development and sales and marketing expense	911	983
Other research and development expenses	241	963
Other	1,596	1,652
	<u>\$ 28,567</u>	<u>\$ 17,558</u>

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

5. Contractual Arrangements and Commitments

Lease Agreements

Facilities

We lease our office and laboratory space under operating leases. Leases for our corporate office space contain an annual escalation clause of approximately 3% and the related rent expense is recognized on a straight-line basis over the term of the respective lease. In connection with a lease agreement, we have a \$0.7 million irrevocable, unconditional standby letter of credit which is secured by a certificate of deposit classified in our consolidated balance sheet in *other assets* as of December 31, 2006 and 2005. Rent expense amounted to approximately \$3.8 million, \$7.3 million and \$7.8 million for the years ended December 31, 2006, 2005 and 2004, respectively. Rent expense is net of sublease income and amounts offset to excess facilities charges (see Note 10, *Restructuring Activities*).

During 2004, 2005 and 2006, we entered into sublease agreements to sublet a portion of our facilities considered to be in excess of current requirements. Total sublease rental income for fiscal years 2006, 2005 and 2004 was \$0.9 million, \$0.2 million and \$21,000, respectively, recorded as an offset to lease expense. Total future sublease income to be recognized over the term of our existing subleases is approximately \$1.2 million.

Aircraft

In 2005, we terminated an aircraft operating lease agreement. Rent expense under the lease amounted to \$1.9 million and \$2.3 million for the years ended December 31, 2005 and 2004, respectively. In 2005 we also made a \$1.2 million payment in connection with the early termination of the lease which is included in *restructuring charges and related asset impairments*.

Capital Leases

In connection with our merger with Novuspharma, we assumed two capital lease agreements to finance lab equipment. One of these capital leases had an interest rate of 5.4% and terminated in March 2006 while the other lease has a rate of 5.1% and terminates in February 2008. We also entered into an additional capital lease in 2006 with a term of 47 months at an interest rate of 6.0%. The gross amount of assets under capital lease obligations was approximately \$0.8 million and \$0.6 million as of December 31, 2006 and 2005, respectively. The related accumulated depreciation was approximately \$0.3 million and \$0.2 million as of December 31, 2006 and 2005, respectively.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Future Minimum Lease Payments

Future minimum lease commitments for noncancelable operating and capital leases at December 31, 2006 are as follows (in thousands):

	<u>Capital Leases</u>	<u>Operating Leases</u>
2007	\$ 98	\$ 8,670
2008	67	5,665
2009	18	5,381
2010	20	5,441
2011	—	5,397
Thereafter	—	4,660
Total minimum lease commitments	\$ 203	\$ 35,214
Less interest	(15)	
Present value of lease obligation	188	
Less current portion of long-term obligation	(90)	
Long-term obligation	\$ 98	

As of December 31, 2006 and 2005, we had a liability of approximately \$4.0 million and \$6.3 million, respectively, in charges for excess facilities under our current operating leases in accordance with SFAS 146. These charges included lease commitments, net of estimated sublease income (see Note 10, *Restructuring Activities*).

Paclitaxel Supply

In September 2001, we entered into a purchase agreement with Natural Pharmaceuticals, Inc., or NPI, to purchase \$6.0 million of paclitaxel, a starting material for XYOTAX, which was to be delivered by NPI over several years. This material was intended to be used primarily for research and development activities. We paid for the entire purchase upon execution of the agreement in 2001 and recorded the amount as a prepaid asset. As we had adequate supply of paclitaxel on hand to support our validation campaigns and clinical activities, we amended our supply agreement with NPI to reduce the amount of material we would receive and we were refunded \$0.8 million of our prepayment. In addition, the agreement, as amended, grants NPI the exclusive right to purchase up to 5 kilograms of our paclitaxel supply at our original cost through September 1, 2007. The amended agreement also allows NPI the right to sell some or all of the paclitaxel supply to its customers and replace the material within 60 days with newer material having a longer expiration date.

As of December 31, 2006 and 2005, we had paclitaxel supply of \$1.1 million and \$2.3 million, respectively, which is included in *prepaid expenses and other current assets* . The amount as of December 31, 2006 includes approximately \$0.4 million in supply due from NPI. These costs have been capitalized since there is a ready market for this active pharmaceutical ingredient. The paclitaxel supply was adjusted during the second quarter of 2005 to reflect a \$1.7 million write-down to its estimated re-sale value based on current prices obtained from an external vendor.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. Convertible Notes and Long-Term Obligations

The following table summarizes the changes in the principal balances of our convertible notes during the years ended December 31, 2006 and 2005 (in thousands):

	7.5% Convertible Senior Notes	6.75% Convertible Senior Notes	4% Convertible Senior Subordinated Notes	5.75% Convertible Senior Subordinated Notes	5.75% Convertible Subordinated Notes
Balance at January 1, 2005	\$ —	\$ —	\$ 75,000	\$ 85,459	\$ 29,640
Issued	—	82,000	—	—	—
Converted	—	(3,000)	(19,850)	(18,530)	—
Balance at December 31, 2005	—	79,000	55,150	66,929	29,640
Issued	66,312	—	—	—	—
Converted	(17,560)	(69,345)	—	(4)	—
Redeemed	—	(2,655)	—	—	—
Exchanged	—	—	—	(39,518)	(1,150)
Balance at December 31, 2006	<u>\$ 48,752</u>	<u>\$ 7,000</u>	<u>\$ 55,150</u>	<u>\$ 27,407</u>	<u>\$ 28,490</u>

7.5% convertible senior notes

In April 2006, we issued approximately \$66.3 million aggregate principal amount of our 7.5% notes, approximately \$33.2 million of which was issued in a registered offering for cash with net proceeds of approximately \$31.2 million, after deducting expenses and the initial purchaser's discounts and commissions. Approximately \$33.2 million was issued in a private exchange for approximately \$39.5 million aggregate principal amount of our 5.75% convertible senior subordinated notes and approximately \$1.2 million aggregate principal amount of our 5.75% convertible subordinated notes. We recognized a net gain of \$8.0 million on the early extinguishment and exchange of these notes which is based on the carrying value of the exchanged notes less the fair value of the new notes, net of issuance costs of \$0.4 million and accrued interest of \$0.9 million attributable to the exchanged notes. We recorded issuance costs related to 7.5% notes of approximately \$2.0 million which are recorded in *other assets* and are being amortized to interest expense using the effective interest method over the five-year life of the notes.

The notes are due April 30, 2011 with interest payable semi-annually in April and October. The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 478.519 shares of common stock per \$1,000 principal amount of the notes, which is subject to adjustments in certain circumstances. This conversion rate is equivalent to a conversion price of approximately \$2.09 per share. On or after April 30, 2009, we have the option to redeem all of the notes for cash at any time at a redemption price equal to par plus accrued and unpaid interest up to but not including the redemption date. Subject to certain conditions, the notes will automatically convert if, at any time after June 26, 2006 and prior to maturity, the closing price per share of our common stock has exceeded 125% of the conversion price then in effect for at least 20 trading days within any 30-consecutive trading day period. In addition, upon certain non-stock changes in control, the holder can require us to repurchase the notes at 100% of their principal amount, plus accrued and unpaid interest to, but not including, the repurchase date. Upon any automatic conversion of the notes, or if the holder exercises their right to require us to repurchase notes in connection with a non-stock change of control, we will pay the holder of the notes a make-whole interest payment equal to \$225 per \$1,000 principal amount of the notes so converted, less any interest paid on such notes prior to the conversion date.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2006, a total of \$17.6 million of our 7.5% notes had been converted into 8.4 million shares of common stock. In connection with the conversion of \$7.4 million of these notes in May 2006, we made a discretionary interest make-whole payment of approximately \$1.7 million which is included in *make-whole interest expense* for the year ended December 31, 2006.

In January and February 2007, an additional \$6.7 million principal of our 7.5% notes was converted into 3.2 million shares of our common stock. In connection with the conversion of \$5.6 million of these notes, we made a discretionary interest make-whole payment of approximately \$0.8 million. We expect to make additional discretionary make-whole payments totaling approximately \$1.5 million to certain note holders during 2007.

6.75% convertible senior notes

In November 2005, we completed the issuance of \$82 million of 6.75% convertible senior notes due October 31, 2010 with interest payable semi-annually in April and October. Net proceeds to us were approximately \$77.7 million, after deducting expenses and the initial purchaser's discounts and commissions. We recorded issuance costs related to the notes of approximately \$4.9 million which includes approximately \$0.6 million related to the Black-Scholes estimated fair value of warrants issued to the initial purchaser of the notes. These issuance costs are recorded in *other assets* and are being amortized to interest expense using the effective interest method over the five-year life of the notes.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 380.37 shares of common stock per \$1,000 principal amount of the notes, which is subject to adjustment in certain circumstances. This conversion rate is equivalent to a conversion price of approximately \$2.63 per share. We also issued warrants to purchase 350,000 shares of common stock within five years at an exercise price of \$3.50 per share to the initial purchaser of these notes. We have the option to redeem all of the notes if the closing price per share of our common stock has exceeded 125% of the conversion price then in effect for at least 20 trading days within any 30-consecutive trading day period. The redemption price will be par including accrued and unpaid interest up to but not including the redemption date. Upon any conversion of the notes, we will pay the holder of the notes a make-whole interest payment equal to \$337.50 per \$1,000 principal amount of the notes so converted, less any interest paid on such notes prior to the conversion date.

On April 30, 2006, holders of the notes had the right to cause us to redeem in cash up to 30% of the aggregate amount of the notes, or approximately \$24.6 million, on a pro-rata basis, excluding any accrued and unpaid interest. Certain holders of the notes exercised their right and we redeemed approximately \$2.7 million in aggregate principal of these notes. For the year ended December 31, 2006 and 2005, \$69.3 million and \$3.0 million of the 6.75% notes had been converted into 26.4 million and 1.1 million shares of common stock, respectively. This resulted in make-whole interest payments of \$23.1 million and \$1.0 million for the year ended December 31, 2006 and 2005, respectively.

Conversion and Placement Agreement

In November 2005, in conjunction with issuance of the 6.75% convertible senior notes, we entered into a Conversion and Placement Agreement, or CAP agreement, with two existing holders of approximately \$18.5 million of our outstanding 5.75% Convertible Senior Subordinated Notes, or 5.75% notes, and approximately \$19.9 million of our 4% Convertible Senior Subordinated Notes, or 4% notes. Pursuant to the original terms of the agreement, the CAP holders agreed to exercise their right to convert their 5.75% notes and 4% notes into approximately 3.3 million shares of our common stock. In connection with the conversion, we also issued to the CAP holders a \$23.6 million conversion inducement which consisted of 3.4 million shares of common stock and

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6.5 million shares issuable upon exercise of zero strike price warrants. The shares and warrants were valued based on the trading price of our common stock on the effective date of the agreement. The conversion inducement was recorded as *debt conversion expense* during the year ended December 31, 2005.

Under the terms of this agreement we were required to file a resale registration statement with respect to these shares which was required to be declared effective by November 30, 2005. We filed the resale registration statement on November 30, 2005, however it was not declared effective until December 2005 and as a result, we were required to make a liquidated damages payment of approximately \$1.2 million which is included in *interest expense* for the year ended December 31, 2005.

Convertible senior subordinated notes

In June 2003, we issued \$75.0 million principal amount of 4.0% convertible senior subordinated notes due July 1, 2010 with interest payable semi-annually in January and July. Net proceeds to us were approximately \$72.1 million, after deducting expenses and the initial purchaser's discounts and commissions. We recorded issuance costs related to the notes of approximately \$2.9 million. These issuance costs are recorded as *other assets* and are being amortized to interest expense using the effective interest method, over the seven-year life of the notes.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 74.0741 shares of common stock per \$1,000 principal amount of notes, which is subject to adjustment in certain circumstances. This conversion rate is equivalent to a conversion price of approximately \$13.50 per share. Prior to maturity, we may redeem the notes upon certain conditions, the most significant of which is that the closing price of our common stock must exceed 150% of the conversion price for at least 20 trading days within a period of 30 consecutive trading days. Upon such redemption, we would make an additional payment of \$280.00 per \$1,000 note, less any interest previously paid on the notes. The holder may elect to convert their notes prior to any such redemption.

In connection with the exchange of convertible subordinated notes in December 2002 as described below, we issued \$85.5 million of 5.75% convertible senior subordinated notes and recorded additional issuance costs of approximately \$2.1 million, which are recorded in *other assets* and are being amortized to interest expense using the effective interest method, over the remaining life of the notes. The terms of the new notes are similar to the convertible subordinated notes except for the conversion price and provisional redemption provision. The conversion rate for these notes is 100 shares per \$1,000 principal note; this is equivalent to a conversion price of \$10.00 per share. We can redeem the notes at specified redemption prices ranging from 103.286% to 100% of the principal amount. The redemption prices will vary depending on the year redeemed. The holder may elect to convert their notes prior to any such redemption.

Convertible subordinated notes

In June and September 2001, we issued a total of \$175.0 million principal amount of 5.75% convertible subordinated notes due June 15, 2008 with interest payable semi-annually in June and December. Net proceeds to us were approximately \$168.0 million, after deducting expenses and the initial purchaser's discounts and commissions. We recorded issuance costs related to the notes of approximately \$7.0 million. Issuance costs are recorded in *other assets* and amortized to interest expense over the life of the notes using the effective interest method.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity or redemption at a conversion rate of 29.4118 shares per each \$1,000 principal note, subject to

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

adjustment in certain circumstances. This is equivalent to a conversion price of \$34.00 per share. We can redeem the notes at specified redemption prices ranging from 103.286% to 100% of the principal amount. The redemption prices will vary depending on the year redeemed. The holder may elect to convert their notes prior to any such redemption.

In December 2002, we completed an exchange offer for the 5.75% convertible subordinated notes, in which approximately \$145.4 million of our convertible subordinated notes were tendered in exchange for approximately \$85.5 million of our new convertible senior subordinated notes. We recognized a net gain of \$55.3 million on the early extinguishment of these notes. This net gain is based on the carrying value of the exchanged notes less the fair value of the new notes, net of issuance costs of \$4.6 million attributable to the exchanged notes. In addition, \$1.2 million of these notes were exchanged for our 7.5% notes in April 2006 as described above.

Embedded Features

The interest make-whole provision of the 7.5% notes represents an embedded derivative which is required to be accounted for separate from the underlying notes. At the issuance of the 7.5% notes, the interest make-whole feature was estimated to have a fair value of approximately \$3.7 million and the initial recorded value of the 7.5% notes was reduced by this allocation. The resulting discount to the notes is being accreted over the life of the notes as additional interest expense using the effective interest method. We recorded interest expense of \$1.4 million for the year ended December 31, 2006, the majority of which represents accelerated accretion due to note conversions. The estimated fair value of the derivative liability will be adjusted quarterly for changes in the estimated market value. The change in the estimated fair value for the year ended December 31, 2006 was \$1.9 million and is included in *gain on derivative liabilities*. At December 31, 2006, we recorded an increase to the derivative balance of \$1.8 million which represents the change in value as a result of the modification of the terms of the make-whole interest provision related to certain investors. At December 31, 2006 the fair value of the derivative was \$3.6 million, \$ 2.3 million of which was recorded in *current portion of derivative liability* and \$1.3 of which was recorded in *7.5% convertible senior notes*.

The interest make-whole provision of the 6.75% notes also represents an embedded derivative which is required to be accounted for separate from the underlying notes. At the issuance of the 6.75% senior notes, the interest make-whole feature was estimated to have a fair value of approximately \$4.5 million and the initial recorded value of the 6.75% senior notes was reduced by this allocation. The resulting discount to the notes will be accreted over the life of the notes as additional interest expense using the effective interest method, of which \$4.0 million and \$0.3 million was recorded for the years ended December 31, 2006 and 2005, respectively, primarily in connection with note conversions. The estimated fair value of the derivative liability will be adjusted quarterly for changes in the estimated market value. Changes in the estimated fair value for the years ended December 31, 2006 and 2005 were \$4.1 million and \$0.2 million, respectively, and included in *gain on derivative liabilities*. At December 31, 2006, the fair value of the derivative was \$0.2 million and was recorded in *6.75% convertible senior notes*.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Long-term obligations

Long-term obligations consist of the following as of December 31 (in thousands):

	<u>2006</u>	<u>2005</u>
Capital lease equipment financing agreement, due May 2010, monthly payments of \$1, including interest at 6.0%	\$ 63	\$ —
Capital lease equipment financing agreement, due February 2008, monthly payments of \$7, including interest at 5.1%	125	177
Capital lease equipment financing agreement, due March 2006, monthly payments of \$6, including interest at 5.4% monthly payments of \$48, including interest at 7.1%	—	49
Excess facilities liability	3,951	6,334
Accrued rent	1,759	1,774
Employee defined benefit plan (see Note 14, <i>Employee Benefit Plans</i>)	923	1,329
European public loans	529	475
Other long-term obligations	133	68
	<u>7,483</u>	<u>10,206</u>
Less current portion	(2,816)	(2,880)
	<u>\$ 4,667</u>	<u>\$ 7,326</u>

Maturities of the convertible senior, convertible senior subordinated, and convertible subordinated notes as well as other long-term obligations listed above, excluding the employee defined benefit plan at December 31, 2006 are as follows (in thousands):

Years Ending December 31,	
2007	\$ 2,816
2008	56,840
2009	659
2010	62,898
2011	49,568
Thereafter	578
	<u>\$ 173,359</u>

7. Agreements with Novartis International Pharmaceutical Ltd.

Co-Development Agreement

In September 2006, we entered into an exclusive worldwide licensing agreement with Novartis International Pharmaceutical Ltd., or Novartis, for the development and commercialization of XYOTAX. Total product registration and sales milestones due from Novartis for XYOTAX under the agreement could reach up to \$270 million. The agreement also provides Novartis with an option to develop and commercialize pixantrone based on agreed terms. If Novartis exercises its option on pixantrone under certain conditions, Novartis would pay CTI a \$7.5 million license fee, up to \$104 million in registration and sales related milestones and a royalty on pixantrone worldwide net sales as well as reimbursement for certain expenses.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Securities Purchase Agreement

In connection with the co-development agreement, we also entered into a securities purchase agreement with Novartis, under which we agreed to sell and Novartis agreed to purchase an aggregate of 8,670,520 shares of our common stock for a total purchase price of \$15 million.

In October 2006, both the co-development and securities purchase agreements became effective upon the receipt of antitrust regulatory clearance, and accordingly, we closed the sale of the shares of common stock to Novartis. Expenses related to this sale were approximately \$0.2 million and were recorded in *common stock* as an offset to proceeds received.

Registration Rights Agreement

In connection with the sale of our common stock, we entered into a registration rights agreement with Novartis, under which we agreed to prepare, file and have declared effective a shelf registration statement with the Securities and Exchange Commission, or SEC, covering the resale of this common stock and to maintain the effectiveness of such registration statement. If we fail to achieve either of these obligations we are required to make certain payments to Novartis of up to 1% per month for each month we are not in compliance with these requirements. The registration statement was declared effective in November 2006.

We analyzed the default payment requirement related to the continuing registration effectiveness obligation in accordance with FSP EITF 00-19-2 which specifies that the contingent obligation to make future payments under a registration payment arrangement should be separately recognized and accounted for under SFAS 5. As we have never had a registration rights agreement lose effectiveness after its initial effectiveness has been declared, we determined that the probability of payment under the registration rights agreement is remote under SFAS 5 guidance. As such, we did not recognize a liability related to the registration payment arrangement.

8. Common Stock Offering

In September 2006, we received \$40 million in gross proceeds from an offering of 23,121,394 shares of our common stock. These shares were sold under an existing shelf offering filed in April 2006 at an offering price of \$1.73 per share. We also issued to the purchasing investors warrants to purchase an additional 5,780,352 shares at \$1.73 per share if exercised within 90 days. We incurred approximately \$2.2 million in expenses related to this offering.

In October 2006, we were notified by the Nasdaq Stock Market, or Nasdaq, that this offering did not comply with the shareholder approval requirements set forth in Nasdaq Marketplace Rule 4350(i)(1)(D). This rule requires shareholder approval for transactions other than “public offerings” that exceed 20% of the outstanding shares at a price less than market value. In response to this notification, we repurchased 1,094,000 shares of common stock and 5,660,352 warrants for an aggregate price of \$3,024,691 thereby reducing the number of shares below the 20% threshold. The Nasdaq has confirmed that the Company has regained compliance with Nasdaq Marketplace Rule 4350(i)(1)(D) and the matter is now closed.

9. Equity Financing Agreement

On June 21, 2006, we entered into a Step-Up Equity Financing Agreement, as amended on December 15, 2006, with Société Générale. Subject to certain conditions, the agreement allows us to issue to Société Générale shares of our common stock in a series of tranches over a period of 24 months beginning January 31, 2007. Under the agreement, we can initially issue up to €15 million worth of our common stock based on a

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

pre-determined formula and have the right to increase the total amount of all issuances to up to €60 million worth of our common stock. Any issuance of our common stock pursuant to this agreement is at our election and we are not required to issue any common stock.

Upon effectiveness of the agreement we paid a fee of approximately \$1.1 million and, including this payment, have incurred total expenses related to this agreement of approximately \$1.2 million which are recorded in *other assets* as of December 31, 2006. In addition, on each settlement of a share issuance, we must pay a subscriber fee equal to 3.5% of the selling price as well as 2.0% of the aggregate selling amount raised during each fiscal quarter. As of December 31, 2006, there have not been any shares of common stock issued under this agreement.

10. Restructuring Activities

During 2005, we reduced our workforce in the U.S. and Europe and terminated our aircraft lease. In conjunction with our workforce reduction, we also vacated a portion of our laboratory and office facilities and recorded excess facilities charges. For the year ended December 31, 2006 and 2005, restructuring and related asset impairment charges totaled approximately \$0.6 million and \$12.8 million, respectively, which is included in *Restructuring charges and related asset impairments* and comprised of the following:

	2006	2005
Excess facilities charges	\$ 667	\$ 7,092
Employee separation cost	(80)	3,478
Aircraft lease termination payment	—	1,170
Asset Impairments	4	1,040
Total restructuring and related asset impairment charges	<u>\$ 591</u>	<u>\$ 12,780</u>

Excess Facilities Charges

Charges for excess facilities relate to our lease obligation for excess laboratory and office space in the U.S. that we have vacated as a result of the restructuring plan. Pursuant to SFAS 146, we recorded restructuring charges when we ceased using this space. For the year ended December 31, 2005 total restructuring charges related to this vacated space was approximately \$7.1 million. The charge is calculated as the present value of total lease commitments, net of estimated sublease income. The additional charges for excess facilities for the year ended December 31, 2006 were due to changes in our estimate of the timing and amount of cash flows related to these excess facilities as well as adjustments due to the passage of time. As of December 31, 2006 we had approximately \$4.0 million accrued related to excess facilities charges, of which approximately \$2.6 million was included in *current portion of long-term obligations* and approximately \$1.4 of which was included in *long-term obligations, less current portion*. We will periodically evaluate our existing needs, the current and estimated future values of our subleases, and other future commitments to determine whether we should record additional excess facilities charges or adjustments to such charges.

Employee Separation Costs

For the year ended December 31, 2005, employee separation costs associated with the layoffs consist primarily of one-time termination benefits, principally severance payments, recognized in accordance with SFAS 146. The adjustment for the year ended December 31, 2006 relates to changes in estimates of amounts due to employees as well as adjustments due to foreign currency fluctuations.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Restructuring Related Asset Impairments

Impairment charges recorded pursuant to SFAS 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, or SFAS 144, primarily include laboratory equipment, computers, and furniture and fixtures which are unlikely to be utilized due to our vacated lab and office space as well as employee terminations and accordingly, have been written down to estimated fair market value primarily based on quoted market prices obtained from external sources.

The following table summarizes the changes in the liability for restructuring activities during the years ended December 31, 2006 and 2005 (in thousands):

	<u>Excess Facilities Charges</u>	<u>Employee Separation Costs</u>	<u>Aircraft Lease Termination</u>
Balance at January 1, 2005	\$ —	\$ —	\$ —
Charges	7,092	3,478	1,170
Foreign currency adjustments	—	(90)	—
Payments	(758)	(1,463)	(1,170)
Balance at December 31, 2005	6,334	1,925	—
Charges	667	(80)	—
Foreign currency adjustments	—	12	—
Payments	(3,050)	(1,830)	—
Balance at December 31, 2006	<u>\$ 3,951</u>	<u>\$ 27</u>	<u>\$ —</u>

11. Divestiture of TRISENOX and Certain Proteasome Assets and Extinguishment of PharmaBio Royalty Obligation

On July 18, 2005, we divested TRISENOX and certain proteasome assets to Cephalon. In addition, we provided transition services related to TRISENOX and proteasome assets for approximately six months subsequent to the closing date. We received aggregate consideration of \$71.9 million for the assets and transition services, net of broker fees. As part of the transaction Cephalon purchased the capital stock of two wholly-owned subsidiaries, Cell Therapeutics (UK) Limited and PolaRx and assumed certain liabilities. There was \$2.4 million in assets and \$1.7 million in liabilities included in the disposal group related to the divestiture. In addition, we may receive up to an additional \$100 million in payments upon achievement by Cephalon of specified sales and development milestones. However, achievement of such milestones is uncertain.

In December 2004, we entered into a financing and services agreement with PharmaBio. In return for cash and services, we were required to pay PharmaBio royalties based on a percentage of net sales of TRISENOX. As a result of the divestiture of TRISENOX, we were required to repay this royalty obligation to PharmaBio. The aggregate termination payment of \$39.4 million was made on July 18, 2005 and a \$6.4 million loss on the extinguishment of this royalty obligation was recognized for the year December 31, 2005.

Under the agreement, we were entitled to receive \$5.0 million in services from PharmaBio and its affiliates (the Prepaid Service Commitment) which may be used through December 31, 2010. As of December 31, 2006, we had \$0.6 million remaining under the Prepaid Service Commitment which is included in *prepaid expenses and other current assets*. As of December 31, 2005, we had \$3.4 million remaining, of which \$2.9 was recorded in *prepaid expenses and other current assets* and \$0.5 million was included in *other assets*.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

12. Capital Stock

In January 2004, we completed our merger with Novuspharma S.p.A and issued 15,629,138 shares of our common stock for all outstanding Novuspharma shares. The total cost of the merger was approximately \$196.1 million.

In August 2004, we received approximately \$49.2 million in gross proceeds from a public offering of 10,350,000 shares of our common stock, including 9,000,000 shares initially sold and an additional 1,350,000 following the underwriter's exercise of their over-allotment option. These shares were sold under a shelf registration statement filed in February 2004 at a public offering price of \$4.75 per share. We incurred approximately \$3.5 million in expenses, including underwriters' discounts and commissions related to this offering.

In December 2004, we received approximately \$18.4 million in gross proceeds from a direct registered offering of approximately 2,585,915 shares of our common stock to several institutional investors. These shares were sold under the same shelf registration statement filed in February 2004 at a price of \$7.10 per share. We incurred expenses of approximately \$0.1 million related to this offering.

In connection with the CAP agreement entered into in November 2005 (see Note 6, *Long-Term Obligations*), we issued 3,323,370 shares of common stock upon conversion of a portion of our 5.75% and 4.0% convertible senior subordinated notes based on the conversion terms of the notes as well as an additional 3,377,932 shares of common stock and 6,500,000 zero strike price warrants to purchase common stock. All of the warrants were exercised during 2006.

We issued 1,141,110 and 26,376,751 shares upon conversion of \$3.0 million and \$69.3 million of our 6.75% convertible senior notes during 2005 and 2006, respectively.

During 2006, we issued 8,402,789 shares upon conversion of \$17.6 million of our 7.5% convertible senior notes.

In September 2006, we issued 23,121,394 shares of stock under a common stock offering and received \$40 million in gross proceeds. We also issued to the purchasing investors warrants to purchase an additional 5,780,352 shares at \$1.73 per share. We incurred approximately \$2.2 million in expenses related to this offering (See Note 8, *Common Stock Offering*).

In October 2006, we repurchased 1,094,000 shares of common stock and 5,660,352 warrants related to the above offering. In November 2006, warrants to purchase 95,000 shares of common stock were exercised and the remaining warrants expired in December 2006.

Also in October 2006, in connection with our licensing and co-development agreement entered into with Novartis, we issued an aggregate of 8,670,520 shares of our common stock for gross proceeds of \$15 million. We incurred expenses of approximately \$0.2 million related to this offering. (See Note 7, *Agreements with Novartis International Pharmaceutical Ltd.*).

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Common Stock Reserved

A summary of common stock reserved for issuance is as follows as of December 31, 2006:

Convertible senior notes	25,991,354
Convertible senior subordinated notes	6,825,888
Convertible subordinated notes	837,941
Equity incentive plans	6,637,095
Common stock warrants	800,000
Employee stock purchase plan	230,895
Restricted share rights	15,666
	<u>41,338,839</u>

13. Stock-Based Compensation

Stock-Based Compensation Expense

On January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R). Prior to January 1, 2006, we accounted for share-based payments under the recognition and measurement provisions of APB 25, and related interpretations, as permitted by SFAS 123. In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. Under our plan, stock options are generally granted at fair market value.

We adopted SFAS 123(R) using the modified-prospective transition method. Under this transition method, beginning on the effective date, or January 1, 2006, compensation cost recognized includes (1) compensation cost for all share-based payments 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 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In addition, in accordance with the modified-prospective transition method, results for prior periods have not been restated to reflect the impact of SFAS 123(R). We use the straight-line single-option method to recognize the value of stock-based compensation expense for all share-based payment awards granted after January 1, 2006. Expense is recognized using the graded-vesting multiple-option method for options granted prior to January 1, 2006.

Under SFAS 123(R), stock-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Based on this, our stock-based compensation is reduced for estimated forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was \$4.1 million, which consisted of \$2.5 million of stock-based compensation expense related to employee stock options and employee stock purchases and \$1.6 million of stock-based compensation expense related to share awards. Stock-based compensation expense recognized for share awards was \$3.3 million and \$4.3 million during the years ended December 31, 2005 and 2004, respectively. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the years ended December 31, 2005. Stock-based compensation expense related to employee stock options and employee stock purchases was \$1.0 million for the year ended December 31, 2004.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes stock-based compensation expense related to employee stock options, employee stock purchases, and share awards under SFAS 123(R) for the year ended December 31, 2006, which was allocated as follows (in thousands):

Research and development	\$ 2,455
Selling, general and administrative	<u>1,671</u>
Stock-based compensation expense included in operating expenses	<u>\$ 4,126</u>

Stock-based compensation had a \$4.1 million effect on our net loss and a \$(0.04) effect on basic and diluted net loss per share for the year ended December 31, 2006. There was no effect on cash flows from operations or financing activities for the periods presented.

SFAS 123(R) requires the disclosure of pro-forma information for periods prior to the adoption. The following table illustrates the effect on net loss and net loss per share for the years ended December 31, 2005 and 2004 if we had recognized compensation expense for all share-based payments to employees based on their fair values (in thousands, except per share amounts):

	Year Ended December 31, 2005	Year Ended December 31, 2004
Net loss, as reported	\$ (102,505)	\$ (252,298)
Add: Stock-based employee compensation included in reported net loss (share awards)	3,253	5,342
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	<u>(5,684)</u>	<u>(11,397)</u>
Pro forma net loss	\$ (104,936)	\$ (258,353)
Basic and diluted net loss per share:		
As reported	\$ (1.59)	\$ (4.67)
Pro forma	\$ (1.63)	\$ (4.78)

Fair value was estimated at the date of grant using the Black-Scholes pricing model, with the following weighted average assumptions:

	Year Ended December 31,		
	2006	2005	2004
Risk-free interest rates	4.8%	4.1%	3.6%
Expected dividend yield	None	None	None
Expected life (in years)	2.8	3.5	4.5
Volatility	74%	90%	98%

The risk-free interest rate used in the Black-Scholes valuation method is based on the implied yield currently available in U.S. Treasury securities at maturity with an equivalent term. We have not declared or paid any dividends and do not currently expect to do so in the future. The expected term of options represents the period that our stock-based awards are expected to be outstanding and was determined based on historical weighted average holding periods and projected holding periods for the remaining unexercised shares. Consideration was given to the contractual terms of our stock-based awards, vesting schedules and expectations of future employee behavior. Expected volatility is based on the annualized daily historical volatility, including consideration of the implied volatility and market prices of traded options for comparable entities within our industry.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Our stock price volatility and option lives involve management's best estimates, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. SFAS 123(R) also requires that we recognize compensation expense for only the portion of options expected to vest. Therefore, we applied an estimated forfeiture rate that we derived from historical employee termination behavior. If the actual number of forfeitures differs from our estimates, additional adjustments to compensation expense may be required in future periods.

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123(R) and EITF 96-18 at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is periodically remeasured as the underlying options vest.

No tax benefits were attributed to the stock-based compensation expense because a valuation allowance was maintained for substantially all net deferred tax assets.

Stock Options

During 2003, shareholders approved the 2003 Equity Incentive Plan, or 2003 Plan, which replaced the 1994 Equity Incentive Plan, or 1994 Plan. The 1994 Plan has since been terminated, except with respect to outstanding awards previously granted thereunder. The 2003 Plan provides for (a) the grant of nonqualified and/or incentive stock options, stock appreciation rights and restricted stock, (b) annual, automatic, non-discretionary grants of non-qualified stock options and restricted stock to non-employee members of our board of directors and (c) the award of stock-based performance bonuses. There are 6,443,289 shares authorized under the 2003 Plan including the authorization for issuance of an additional 5,000,000 shares of common stock as set forth in an August 2004 amendment to the 2003 Plan approved by our shareholders at our 2004 Annual Meeting of Shareholders and 293,289 shares which had been reserved but not granted under the 1994 Plan.

In December 2003, the Board of Directors approved the assumption and amendment and restatement of the Cell Therapeutics, Inc. Novuspharma S.p.A. Stock Option Plan, or 2004 Plan, in connection with the merger between CTI and Novuspharma. The Plan provided for the grant of nonqualified stock options and restricted stock to certain of our officers, employees, members of our Board of Directors and consultants. There were 350,000 shares of common stock authorized under the 2004 Plan which was terminated as of December 31, 2006.

The Plans are administered by the Compensation Committee of the Board of Directors which has the discretion to determine which employees, consultants and directors shall be granted options. The options are typically exercisable ratably over a four-year period commencing one year from the date of grant, and expire not more than 10 years from the date of grant. As of December 31, 2006, 481,542 shares of common stock were available for future grants.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarized stock option activity for all of the stock option plans is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (Thousands)
Outstanding January 1, 2004 (3,314,006 exercisable)	5,909,000	\$ 15.45		
Granted	1,260,000	\$ 7.63		
Exercised	(529,000)	\$ 3.43		
Forfeited	(681,000)	\$ 15.25		
Expired	—	\$ —		
Outstanding December 31, 2004 (3,764,175 exercisable)	5,959,000	\$ 14.89		
Granted	2,949,000	\$ 4.13		
Exercised	(45,000)	\$ 7.75		
Forfeited	(2,673,000)	\$ 12.46		
Expired	(75,000)	\$ 6.84		
Outstanding December 31, 2005 (3,619,426 exercisable)	6,115,000	\$ 10.95		
Granted	1,082,000	\$ 1.75		
Exercised	—	\$ —		
Forfeited	(480,000)	\$ 4.09		
Expired	(561,000)	\$ 11.29		
Outstanding December 31, 2006	6,156,000	\$ 9.84	6.9	\$ 80
Vested or expected to vest at December 31, 2006	5,859,756	\$ 10.18	6.8	\$ 78
Exercisable at December 31, 2006	4,710,761	\$ 11.87	6.3	\$ 53

The weighted average exercise price of shares exercisable at December 31, 2005 and 2004 was \$15.61 and \$18.74, respectively. The total intrinsic value of options exercised during the years ended December 31, 2005 and 2004 was \$0.2 million and \$2.3 million, respectively. The weighted average fair value of options granted was \$0.89, \$2.72 and \$5.41 during 2006, 2005, and 2004, respectively.

In 2004, we recorded \$1.1 million in equity-based compensation expense resulting from an award modification accounted for in accordance with FIN 44, *Accounting for Certain Transactions Involving Stock Compensation*, using the intrinsic value method. The award modification resulted in the recognition of expense related to 193,558 options granted in prior years and 26,667 restricted shares issued in 2004.

In May 2001, the Compensation Committee of the Board of Directors approved the rescission of certain stock option exercises that two officers and a consultant had made in January 2001. In exchange for the return of 91,384 shares of our common stock, we reinstated their original option grant and returned to them the related aggregate exercise price of \$0.3 million. These options are subject to variable stock compensation accounting until the earlier of the expiration of the option grants or the end of the tax year in which the options are exercised. As of December 31, 2006, 19,170 options are still subject to variable stock compensation accounting.

In accordance with EITF 96-18, all equity instruments issued to non-employees are accounted for at the estimated fair value of the equity instruments. The value of the instrument is amortized to expense over the vesting period with final valuation measured on the vesting date. At December 31, 2006, 2005 and 2004, options to acquire 55,000, 50,368 and 107,537 shares of common stock, respectively, were accounted for based on their estimated fair values. We recorded compensation expense of \$19,000 and \$76,000 in 2006 and 2004, respectively and reversed previously recorded stock compensation expense of \$49,000 in 2005 related to the issuance of these stock options.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes information about common stock options outstanding at December 31, 2006:

Range of Exercise Prices	Options Outstanding			Exercisable Options Outstanding (Without Restriction)	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 1.36 – \$ 2.36	1,794,348	9.23Years	\$ 2.01	725,525	\$ 2.02
\$ 2.43 – \$ 2.97	1,278,948	6.74Years	\$ 2.85	1,162,354	\$ 2.86
\$ 3.06 – \$ 8.10	1,274,152	6.20Years	\$ 5.91	1,149,481	\$ 5.78
\$ 8.23 – \$20.48	671,125	6.61Years	\$ 9.98	536,421	\$ 9.99
\$22.40 – \$47.28	1,136,980	4.36Years	\$ 34.40	1,136,980	\$ 34.40
\$ 1.36 – \$47.28	<u>6,155,553</u>	6.90Years	\$ 9.84	<u>4,710,761</u>	\$ 11.87

Restricted Stock

We issued 126,390, 2,292,291 and 345,082 shares of restricted common stock in 2006, 2005 and 2004, respectively. The amount granted in 2006 does not include 1.4 million shares contingently granted based on approval of an increase in our authorized shares as these are not included in our shares issued and outstanding. Additionally, 134,105, 654,743 and 30,450 shares of restricted stock were cancelled during 2006, 2005 and 2004, respectively. The weighted average fair value of restricted shares issued during 2006, 2005 and 2004 was \$1.76, \$4.90 and \$7.79, respectively.

Deferred stock-based compensation recorded for the restricted share grants for the years ended December 31, 2005 and 2004 was approximately \$4.4 million and \$1.4 million respectively, which generally represented the fair value of our stock issued on the date of grant. We reversed deferred stock-based compensation of \$2.2 million and \$0.4 million in 2005 and 2004, respectively, related to cancellations of restricted shares. In 2006 we reversed all remaining deferred stock-based compensation in connection with our implementation of SFAS 123R.

We also issued 103,665 restricted share rights to non-employees in 1998 for which ownership vests upon the achievement of clinical trial milestones (see Note 18, *Significant Agreements*). Upon entering into an amendment to the PG-TXL License Agreement in February 2006, we issued 87,999 shares of common stock upon the exercise of these restricted share rights and recorded a research and development expense of approximately \$0.2 million for the year ended December 31, 2005.

A summary of the status of nonvested share awards as of December 31, 2006 and changes during the period then ended, is presented below:

	Nonvested Shares	Weighted Average Grant Date Fair Value Per Share
Nonvested at December 31, 2005	1,608,000	\$ 4.92
Granted	126,000	\$ 1.76
Vested	(873,000)	\$ 3.82
Forfeited	(134,000)	\$ 2.79
Nonvested at December 31, 2006	<u>727,000</u>	\$ 6.09

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The total fair value of share awards vested during the year ended December 31, 2006, 2005 and 2004 was \$1.5 million, \$2.1 million and \$1.5 million, respectively.

As of December 31, 2006, the total remaining unrecognized compensation cost related to unvested stock options and share awards amounted to \$1.0 million, which will be amortized over the weighted-average remaining requisite service period of 1.3 years. This amount does not include unrecognized compensation cost related to 525,000 shares of contingent share awards granted during 2005 and 1.4 million contingent share awards granted during December 2006.

Employee Stock Purchase Plan

We maintain an Employee Stock Purchase Plan, or the Purchase Plan, under which eligible employees may purchase a limited number of shares of our common stock at 85% of the lower of the subscription date fair market value and the purchase date fair market value. There are two six-month offerings per year. Under the Purchase Plan, we issued 14,064, 34,398 and 64,361 shares to employees in 2006, 2005 and 2004, respectively. The Purchase Plan terminated on April 29, 2006; however, an extension of the term to April 29, 2016 is subject to shareholder approval. If this extension is approved, there are 230,895 shares reserved for future purchases as of December 31, 2006.

Warrants

In 1998, we issued contingently exercisable warrants to purchase 350,000 shares of our common stock in connection with a license agreement with PG-TXL Company, L.P. at a per share exercise price of \$20.00. The warrants expire in November 2008. In October 2001, we entered into a licensing agreement with Chugai Pharmaceutical Co, Ltd., or Chugai, allowing them to develop XYOTAX within certain territories. The signing of this agreement qualified as an exercise event, and the PG-TXL warrants became exercisable at an exercise price of \$20.00. No warrants have been exercised as of December 31, 2006.

In 2002, we entered into an agreement with The Hope Heart Institute for research services. In connection with this agreement, we issued fully-vested warrants to purchase 100,000 shares of common stock at an exercise price of \$10.00 per share. The warrants expire in November 2007. Phillip M. Nudelman, Ph.D., is the chairman of our board of directors, and a member of our audit, compensation, and nominating and governance committees, and President, Chief Executive Officer and a member of the board of directors of the Hope Heart Institute (see Note 19, *Related Party Transactions*). No warrants have been exercised as of December 31, 2006.

In connection with our November 2005 6.75% convertible senior notes offering, we issued warrants to purchase 350,000 shares of common stock within five years at an exercise price of \$3.50 per share to the initial purchaser of these notes. The estimated fair value of the warrants of approximately \$0.6 million was capitalized as a debt issuance cost and is being amortized over the life of the convertible senior notes of five years. No warrants have been exercised as of December 31, 2006.

In connection with the CAP agreement, in November 2005 we issued 6.5 million zero strike price warrants as well as 3.4 million shares to two investors of our 6.75% convertible senior notes for an inducement to convert \$38.4 million of our outstanding convertible senior subordinated notes. The conversion inducement was recorded as a debt conversion expense. (see Note 6, *Long-Term Obligations*). These warrants expire in October 2010. All warrants were exercised during 2006.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

14. Employee Benefit Plans

CTI's U.S. employees participate in the Cell Therapeutics, Inc. 401(k) Plan whereby eligible employees may defer up to 80% of their compensation, up to the annual maximum allowed by the Internal Revenue Service. We may make a discretionary matching contributions based on certain plan provisions. We made contributions of approximately \$0.1 million, \$0.2 million and \$0.3 million during the years ended December 31, 2006, 2005 and 2004, respectively.

In connection with our merger with Novuspharma, on January 1, 2004, we assumed a defined benefit plan and related obligation for benefits owed to our Italian employees who, pursuant to Italian law, are entitled to a lump sum payment upon separation from the Company. Related costs are accrued over the employees' service periods based on compensation and years of service. In accordance with EITF 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan*, we have elected to carry the obligation under the plan at the amount of the vested benefit obligation which is defined as the actuarial present value of the vested benefit to which the employee is entitled if the employee separates immediately. Benefits of approximately \$0.8 million, \$0.6 million and \$0.2 million were paid to employees who separated from the Company during 2006, 2005 and 2004, respectively. As of December 31, 2006 and 2005, the vested benefit obligation was approximately \$0.9 million and \$1.3 million, respectively and was included in *long-term obligations*.

15. Segment Information and Other Data

We consider our operations to be a single operating segment, focused in the development, acquisition and commercialization of novel treatments for cancer. Financial results of this reportable segment are presented in the accompanying consolidated financial statements.

Because we sold our only commercial product, TRISENOX, to Cephalon on July 18, 2005, there were no product sales during 2006. During the years ended December 31, 2005 and 2004, TRISENOX product sales from major customers as a percentage of total product sales were as follows:

	<u>2005</u>	<u>2004</u>
Customer A	32%	35%
Customer B	21%	24%
Customer C	22%	20%

The following table depicts product sales attributed to external customers based the following geographic locations (in thousands):

	<u>Year Ended December 31,</u>	
	<u>2005</u>	<u>2004</u>
North America	\$ 11,413	\$ 22,501
Europe	1,932	4,427
Asia	2,747	2,666
	<u>\$ 16,092</u>	<u>\$ 29,594</u>

The following table depicts long-lived assets based on the following geographic locations (in thousands):

	<u>Year Ended December 31,</u>	
	<u>2006</u>	<u>2005</u>
United States	\$ 24,663	\$ 29,882
Europe	12,620	18,482
	<u>\$ 37,283</u>	<u>\$ 48,364</u>

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

16. Net Loss Per Share

Basic and diluted net loss per share is calculated using the weighted average number of shares outstanding as follows (in thousands, except per share amounts):

	Year Ended December 31,		
	2006	2005	2004
Net loss	\$ (135,819)	\$ (102,505)	\$ (252,298)
Basic and diluted:			
Weighted average shares outstanding	113,566	66,116	54,795
Less weighted-average restricted shares outstanding	(1,283)	(1,563)	(743)
Shares used in calculation of basic and diluted net loss per share	<u>112,283</u>	<u>64,553</u>	<u>54,052</u>
Net loss per share:			
Basic and diluted	<u>\$ (1.21)</u>	<u>\$ (1.59)</u>	<u>\$ (4.67)</u>

As of December 31, 2006, 2005 and 2004, options, warrants, unvested restricted share awards and rights and convertible debt aggregating 41,353,113, 56,825,236 and 22,235,863 common equivalent shares, respectively, prior to the application of the treasury stock method for options and warrants, were not included in the calculation of diluted net loss per share as their effects on the calculation are anti-dilutive.

17. Income Taxes

As of December 31, 2006, we had net operating loss carryforwards of approximately \$554.1 million, of which \$56.9 million relates to stock option deductions, and research credit carryforwards of approximately \$18 million. The carryforwards begin to expire in 2007.

Due to our equity financing transactions, and other ownership changes as defined in Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, we incurred "ownership changes" pursuant to the Code. Accordingly, our use of net operating loss carryforwards is limited to approximately \$12.7 million annually for losses incurred prior to August 2, 2004 (which aggregate approximately \$360.0 million). Additionally, all losses incurred prior to March 27, 1997 (which aggregate \$75.5 million) are subject to an annual limitation of approximately \$4.2 million. All losses may also be subject to future ownership change limitations. To the extent that any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried over to subsequent years until the earlier of its utilization or the expiration of the relevant carryforward period, which is generally 15-20 years. It is currently expected that approximately \$9.7 million of the losses incurred prior to March 27, 1997 will expire unused due to the limitations under Section 382 alone. Additional net operating losses may expire if we do not generate sufficient income to utilize the losses before their normal expiration.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying values of assets and liabilities for financial reporting purposes and income tax reporting. We recognized a valuation allowance equal to net deferred tax assets due to the uncertainty of realizing the benefits of the assets. Our valuation allowance increased \$27.2 million, \$29.6 million, and \$52.7 million during 2006, 2005 and 2004, respectively.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Significant components of our deferred tax assets and liabilities as of December 31 are as follows (in thousands):

	<u>2006</u>	<u>2005</u>
Deferred tax assets:		
Net operating loss carryforwards	\$ 188,378	\$ 138,677
Capitalized research and development	68,994	64,218
Intangible asset	—	26,453
Research and development tax credit carryforwards	17,963	16,932
Debt issue costs	—	7,110
USAO Settlement	3,570	—
Warrants issued	3,485	3,319
Stock based compensation	2,865	1,910
Lease liability and building impairments	1,606	2,417
Charitable contributions carryforward	2,025	2,058
Other deferred tax assets	2,905	2,256
Gross deferred tax assets	291,791	265,350
Less valuation allowance	(289,828)	(262,668)
	1,963	2,682
Deferred tax liabilities:		
GAAP adjustments on Novuspharma merger	(1,626)	(1,995)
Deductions for tax in excess of financial statements	(337)	(687)
Gross deferred tax liabilities	(1,963)	(2,682)
Net deferred tax assets	<u>\$ —</u>	<u>\$ —</u>

Subsequent to 2005, we had a change in the tax treatment related to a gain on the transfer of an intangible asset, thus resulting in a change in tax basis. Accordingly, we reclassified \$26.5 million from an intangible deferred tax asset to the net operating loss carryforward deferred tax assets.

The reconciliation between our effective tax rate and the income tax rate as of December 31 is as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal income tax rate	(34%)	(34%)	(34%)
Research and development tax credits	(1)	(1)	(1)
Permanent difference—IPRD	—	—	12
Permanent difference—other	12	1	1
Valuation allowance	20	30	21
Other	3	4	1
Net effective tax rate	<u>— %</u>	<u>— %</u>	<u>— %</u>

18. Significant Agreements

PG-TXL Company, L.P.: In 1998, we entered into an agreement with PG-TXL Company, L.P., as amended in February 2006, granting us an exclusive worldwide license for the rights to polyglutamic acid paclitaxel, a water soluble form of the cancer drug Taxol, and to all potential uses of PG-TXL Company, L.P.'s polymer technology. Under the terms of the agreement, we acquired the rights to the research, development, manufacture, marketing and sale of anti-cancer drugs developed using this polymer technology.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

We are obligated to make payments to PG-TXL Company upon the achievement of certain development and regulatory milestones. To date we have made \$5.6 million in milestone payments and could be obligated to make additional payments of up to \$14.9 million in the future if additional milestones are met. We also granted warrants to purchase 350,000 shares of our common stock to PG-TXL Company, L.P. which became exercisable upon our entering a licensing agreement for XYOTAX with Chugai Pharmaceutical Co., Ltd (see Note 13, *Stock Based Compensation*).

In connection with the agreement with PG-TXL Company, we also entered into Signing Bonus and Restricted Stock and Share Grant Agreements and Consulting Agreements with certain individuals affiliated with PG-TXL Company, L.P., or the PG-TXL Affiliates. The Company also granted 103,665 restricted share rights to the PG-TXL Affiliates, 87,999 of which vested and were issued in February 2006 in connection with the amendment to the License Agreement. For the year ended December 31, 2005, we recorded approximately \$0.2 million in research and development expense in anticipation of the vesting of these restricted share rights. The remaining restricted share rights vest upon certain performance conditions which include successfully completing a phase III clinical trial of a licensed product and receiving regulatory approval of an NDA by the FDA. We will begin to record compensation expense at the time the vesting of the share rights become probable.

Chugai Pharmaceutical Co., Ltd.: In October 2001, we entered into a licensing agreement with Chugai for the development and commercialization of XYOTAX in several Asian territories. Upon execution of the agreement, Chugai paid us a \$3.0 million upfront fee which was recorded as deferred revenue and originally recognized as revenue over the estimated development period of approximately seven years on a straight-line basis. We recognized \$0.4 million of this revenue as well as approximately \$0.8 million in development expenditure reimbursements from Chugai during 2004. In October 2005, Chugai notified us of their intent to terminate the agreement and accordingly, we recognized the remaining deferred revenue of \$1.4 million in the fourth quarter of 2005 as there was no additional planned development period. The agreement was terminated effective March 2006.

Nippon Shinyaku Co., Ltd.: In December 2002, we entered into a distribution agreement with Nippon Shinyaku Co., Ltd., or Nippon which Cephalon assumed in connection with the TRISENOX divestiture in July 2005. This agreement granted an exclusive license to Nippon to market and distribute TRISENOX in Japan, South Korea and Taiwan. Upon execution of the agreement, Nippon paid us a \$750,000 initial payment, which was recorded as deferred revenue and was recognized as revenue over the performance period of approximately two years on a straight-line basis. We recognized \$0.2 million of revenue during 2004. As of December 31, 2004 all deferred revenue related to the initial payment had been recognized. We also received and recognized as revenue \$0.5 million milestone payments in 2004 related to Nippon's receipt of marketing approval and submission of an NDA in Japan, respectively. In December 2004, Nippon launched TRISENOX for the treatment of relapsed/refractory APL in Japan. Pursuant to a supply agreement we entered into with Nippon, we recorded \$1.3 million and \$0.8 million in product sales during 2005 and 2004, respectively.

Other Significant Agreements: We have several agreements with clinical research organizations, third party manufacturers, and distributors which have a duration greater than one year for the development of our products.

19. Related Party Transactions

In the case of termination, we have severance agreements with our executive officers that provide benefits for eighteen to twenty-four months.

CELL THERAPEUTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On April 8, 2002, before the passage of the Sarbanes Oxley Act of 2002, we extended a loan of \$3.5 million to Dr. James A. Bianco, our president and chief executive officer, which bore interest at the six-month LIBOR rate plus 2.25%, adjusted semi-annually, and was due on April 8, 2004. Dr. Bianco paid accrued interest on the loan through October 2003. Prior to April 8, 2004, Dr. Bianco informed the board that he would not be able to repay this loan, including accrued interest, in full when due on April 8, 2004. On April 8, 2004, in accordance with the terms of the original loan agreement, the interest rate on the loan increased by an additional 3%. On October 22, 2004, Dr. Bianco paid the loan and all outstanding accrued interest in full.

In November 2002, we entered into a two-year Sponsored Research Agreement with the Hope Heart Institute, a non-profit corporation, to perform research specified by us and reviewed by a joint research committee comprised of individuals from our company and from the Hope Heart Institute. In addition to monthly payments, we granted a fully vested warrant to the Hope Heart Institute to purchase 100,000 shares of our common stock at a purchase price of \$10.00 per share (see Note 13, *Stock Based Compensation*). Phillip M. Nudelman, Ph.D., is the chairman of our board of directors, and a member of our audit, compensation, and nominating and governance committees, and President, Chief Executive Officer and a member of the board of directors of the Hope Heart Institute. Jack W. Singer, M.D., who is a member of our board of directors and our Executive Vice President, Chief Medical Officer, was a member of the Scientific Advisory Board of the Hope Heart Institute in 2002. During 2004, we made payments to the Hope Heart Institute of \$45,000 for research related expenses. We also made charitable contributions of \$6,500, \$24,000 and \$11,000 in 2006, 2005 and 2004, respectively. In 2004, we terminated the Sponsored Research Agreement.

In December 2004, we entered into a licensing agreement with DiaKine Therapeutics, Inc., or DiaKine, for the development and commercialization of Lisofylline. We received an upfront payment of \$250,000 in 2004 and additional payments of \$427,000 in 2005. These payments were recorded as deferred revenue and are being recognized as revenue over the estimated development term in the agreement of December 31, 2013. Jack W. Singer, M.D., is a member of the board of Directors for DiaKine.

20. Legal Proceedings

On February 10, 2004, Micromet AG, or Micromet, a Munich, Germany-based company, filed complaints against us in the federal district court for the Western District in the State of Washington, asserting that Cell Therapeutics Europe S.r.l., or CTI-Europe, formerly known as Novuspharma S.p.A., had purportedly breached a contract with Micromet for the development of MT-201, a fully human antibody targeting the EP-CAM molecule. The claims alleged that CTI-Europe failed to pay for certain milestones and development expenses owed under the contract. On February 23, 2004, we answered the complaint, denying the substance of the allegations and filed counterclaims for breach of contract and for rescission of the contract based on Micromet's misrepresentations and failures to disclose material information including preclinical trial tests which were determined to be invalid. On May 3, 2006, we entered into a settlement and release with Micromet regarding this lawsuit pursuant to which we paid Micromet approximately \$1.9 million in cash and the lawsuit was dismissed with prejudice.

Beginning in March 2005, a number of shareholder class actions, alleging violations of federal securities laws, were filed against CTI, James Bianco and Max Link. These actions have been consolidated in the United States District Court for the Western District of Washington. On November 7, 2005, the plaintiffs filed a Consolidated and Amended Class Action Complaint against CTI, James Bianco and Jack Singer. The Consolidated and Amended Complaint asserts claims arising under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder on behalf of a class of purchasers of common stock during the period from November 14, 2003 to March 7, 2005, or the Class Period. Plaintiffs alleged that the defendants violated federal securities laws by, among other things, making false statements of material facts and/or omitting to state material facts to make the statements not misleading in connection with the results of the Company's STELLAR clinical trials for its drug XYOTAX. On January 6, 2006, CTI filed a motion to dismiss this class

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action complaint. On May 4, 2006 the Court granted CTI's motion to dismiss this lawsuit with leave to the plaintiffs to amend. On June 8, 2006 the Court entered a dismissal of this lawsuit with prejudice.

On May 9, 2005, Terence Fernandes, a shareholder of CTI, filed a complaint in the Superior Court of the State of Washington, King County on behalf of CTI against members of CTI's board of directors. The shareholder derivative action alleged breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment since June 7, 2004. On December 7, 2005, plaintiff filed an amended complaint and defendants filed a motion to dismiss on February 6, 2006, to which plaintiffs responded on March 10, 2006. Defendants filed a reply brief on April 10, 2006. On June 22, 2006 the Court granted CTI's motion to dismiss this lawsuit with leave to the plaintiffs to amend. On July 31, 2006, after the period of time for the plaintiffs to amend the complaint had tolled, defendants filed a motion to dismiss this lawsuit with prejudice for the failure of the plaintiffs to amend the complaint. On August 23, 2006, the Court entered a dismissal of this lawsuit with prejudice.

In October 2004, we announced that the United States Attorney's Office, or USAO, for the Western District of Washington had initiated an investigation into certain of our business practices relating to TRISENOX. USAO's investigation relates to our promotional practices relating to TRISENOX; our reporting of revenue relating to TRISENOX sales; and statements made by our representatives, and our expert third party reimbursement consultant, relating to the eligibility of TRISENOX for Medicare reimbursement when the drug was used to treat certain off-label indications. USAO has issued subpoenas to third parties relating to its investigation. We are fully cooperating with USAO (through the provision of documents and periodic meetings) and have not received a subpoena relating to the matter. We cannot predict whether USAO will bring formal criminal enforcement proceedings (and USAO has not indicated that it will). Claims associated with the above-referenced as well as related conduct have been filed against us under seal on behalf of the government by a private party in a qui tam action. Based on information currently available to us, we believe that the USAO may recommend to the Department of Justice that the government intervene in the qui tam action, as is its right, and assume the conduct of this lawsuit. We believe that regardless of whether the government or the private party pursues this lawsuit that one of the primary claims that might be pursued would be that we violated the Federal False Claims Act by receiving reimbursement from Medicare for improper off-label use of TRISENOX or otherwise ineligible sales of TRISENOX over the period ranging from October 2000 until TRISENOX' disposition to Cephalon in July of 2005. During this period we utilized a third party reimbursement expert.

We have reached an oral agreement in principle with the USAO regarding the material terms of a settlement. The final terms and details of this settlement are subject to change and pending the completion and execution of a definitive settlement agreement between the Company and the USAO, but we understand that the agreement in principle is that we will make a single payment of \$10.5 million to the USAO in return for a release of all government claims in connection with the qui tam action and related matters. We would not make any admission of wrongdoing as part of this settlement. There is no guarantee that the Company and the USAO will be able to complete a definitive settlement agreement on the terms of the oral agreement in principle or at all. This settlement does not address separate claims brought against the Company by the private party plaintiff in such matters, which generally relate to attorney's fees and employment related claims. We believe that claims related to wrongful termination are not meritorious.

On January 22, 2007, we filed a complaint in King County Washington Superior Court against The Lash Group, Inc. and Documedics Acquisition Co., Inc., our former third party reimbursement expert, seeking recovery of damages, including losses incurred by the Company in connection with its above referenced USAO investigation, defense and settlement of claims by the government concerning Medicare reimbursement for TRISENOX. On February 28, 2007, defendant The Lash Group, Inc. removed the case to federal court in the Western District of Washington.

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With the exception of \$10.5 million included in *accrued expenses* related to the USAO litigation matter, we have not recorded a reserve for any of the above matters as of December 31, 2006.

In addition to the litigation discussed above, we are from time to time, subject to legal proceedings and claims arising in the ordinary course of business, some of which may be covered in whole or in part by insurance.

21. Subsequent Events

Reverse Stock Split

In February 2007, our Board of Directors authorized a one-for-four reverse split of our common stock which we expect to take effect on or around April 15, 2007. The reverse split will affect all shares of our common stock, including underlying stock options and other convertible instruments outstanding immediately prior to the effective time of the reverse split.

Preferred Stock Offering

In February 2007, we issued 20,000 shares of our Series A 3% convertible preferred stock, or preferred stock, in a registered offering at an issue price of \$1,000 per share, and warrants to purchase an additional 5,979,065 shares of our common stock, no par value at an exercise price of \$1.61 per share.

The preferred stock is convertible at any time into a number of shares of our common stock determined by dividing the stated value of the preferred stock to be converted by the conversion price, which is initially \$1.6725. The initial conversion price is subject to adjustment in certain events.

The warrants will only become exercisable on or after the date upon which all necessary corporate and shareholder action to approve an amendment to our articles of incorporation to increase the number of authorized shares of common stock to an amount sufficient to permit the issuance of all shares of common stock issuable upon exercise of the warrants shall have been taken and such amendment shall have been accepted by the Secretary of State of the State of Washington.

As of March 7, 2007, 12,055 shares of preferred stock had been converted into 7,207,767 shares of common stock.

22. Unaudited Quarterly Data

The following table presents summarized unaudited quarterly financial data (in thousands, except per share data):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(As Restated)	(As Restated)	(As Restated)	
2006				
Revenues	\$ 20	\$ 20	\$ 20	\$ 20
Gross profit	20	20	20	20
Operating expenses	(26,516)	(23,562)	(23,700)	(24,902)
Net loss	(51,916)	(20,472)	(27,832)	(35,599)
Net loss per share—basic and diluted	(0.58)	(0.20)	(0.25)	(0.25)
2005				
Revenues	\$ 6,140	\$ 7,468	\$ 1,291	\$ 1,193
Gross profit	5,894	7,256	1,231	1,193
Operating income (expenses)	(41,888)	(40,254)	(713)(i)	9,030(i)
Net loss	(39,132)	(36,175)	(8,504)	(18,694)
Net loss per share—basic and diluted	(0.62)	(0.57)	(0.13)	(0.27)

(i) In the third and fourth quarters of 2005, we recognized the gain on divestiture of TRISENOX of \$30.5 million and \$40.7 million, respectively.