UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/A

Amendment No. 1

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

For the Quarterly Period Ended June 30, 2009

or

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

For the Transition Period From to

Commission File Number 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**11-3547680**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
23 Main Street, Holmdel, NJ	**07733**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (732) 528-2600

(Former name, former address and former fiscal year, if changed since last report): Not Applicable

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

* The registrant has not yet been phased into the interactive data requirements

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at July 31, 2009**
Common Stock, par value $0.001	**157,004,974 shares**

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EXPLANATORY NOTE

Vonage Holdings Corp. (the Company) is filing this Amendment No. 1 on Form 10-Q/A (this 10-Q/A) to amend the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 originally filed on August 6, 2009 (the Form 10-Q). This filing corrects the computation of diluted net income (loss) per share, originally reflected as $0.05 income per share, to be a diluted net loss of $0.02 per share for the six months ended June 30, 2009, as the Company did not originally take into account the change in the fair value of the embedded derivative related to the conversion option in the Company s convertible notes. Previously reported net income of $7,556 and basic net income per share of $0.05 for the six months ended June 30, 2009 were not affected. Although the error was immaterial to the financial statements for the three and six months ended June 30, 2009, the Company has elected to file this 10-Q/A rather than wait to reflect the correction in its next periodic filing, which will not be made until November 2009. The revised presentation of diluted net income (loss) per share is set forth in Part I, Item 1 in the Consolidated Statements of Operations and on page 9 under Note 1. Basis of Presentation and Significant Accounting Policies Significant Accounting Policies Earnings per Share.

Pursuant to Rule 12b-15 under the Securities Exchange Act of 1934, new certifications of the Company s principal executive officer and principal financial officer are being filed as exhibits to this 10Q/A and a reference to this has been made in Part II, Item 6.

The remaining items contained within this 10Q/A consist of all other items originally contained in the Form 10-Q. These remaining items are not amended hereby, but are included for the convenience of the reader. Except for the forgoing amended information, this 10Q/A continues to describe conditions as of the date of the filing of the Form 10-Q, and the Company has not updated the disclosures contained herein to reflect events that occurred at a later date. The Company is concurrently filing an amendment to its Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 to similarly correct the computation of diluted net income (loss) per share for the three months then ended.

Financial Information Presentation

For the financial information discussed in this Quarterly Report on Form 10-Q/A, other than per share and per line amounts, dollar amounts are presented in thousands, except where noted.

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VONAGE HOLDINGS CORP.

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Part I Financial Information

Item 1. Financial Statements

VONAGE HOLDINGS CORP.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	June 30, 2009 (unaudited)	December 31, 2008
Assets		
Assets		
Current assets:		
Cash and cash equivalents	$ 56,000	$ 46,134
Accounts receivable, net of allowance of $2,625 and $2,045, respectively	23,115	17,696
Inventory, net of allowance of $1,452 and $1,405, respectively	14,390	10,360
Deferred customer acquisition costs, current	21,490	24,002
Prepaid expenses and other current assets	20,964	18,325
Total current assets	135,959	116,517
Property and equipment, net of accumulated depreciation	87,086	98,292
Software, net of accumulated depreciation	33,798	34,368
Deferred customer acquisition costs, non-current	11,980	20,393
Debt related costs, net	10,277	11,541
Restricted cash	40,133	39,585
Intangible assets, net	4,529	5,400
Other assets	9,794	10,809
Total assets	$ 333,556	$ 336,905
Liabilities and Stockholders Equity (Deficit)		
Liabilities		
Current liabilities:		
Accounts payable	$ 23,515	$ 33,978
Accrued expenses	83,144	73,482
Deferred revenue, current portion	63,267	63,155
Current maturities of capital lease obligations	1,372	1,252
Current portion of long-term debt	1,303	1,303
Total current liabilities	172,601	173,170
Notes payable, net of discount	201,782	192,747
Derivative embedded within convertible note, at fair value	18,600	
Deferred revenue, net of current portion	13,845	23,058
Capital lease obligations, net of current maturities	20,234	20,947
Other liabilities, net of current portion in accrued expenses	14,981	17,725
Total liabilities	442,043	427,647

Commitments and Contingencies		
Stockholders Equity (Deficit)		
Common stock, par value $0.001 per share; 596,950 shares authorized at June 30, 2009 and December 31, 2008; 158,542 and 158,201 shares issued at June 30, 2009 and December 31, 2008, respectively; 156,936 and 156,648 shares outstanding at June 30, 2009 and December 31, 2008, respectively	159	158
Additional paid-in capital	947,719	980,768
Stock subscription receivable	(5,195)	(5,195)
Accumulated deficit	(1,038,082)	(1,052,861)
Treasury stock, at cost, 1,606 shares at June 30, 2009 and 1,553 at December 31, 2008	(12,727)	(12,704)
Accumulated other comprehensive income (loss)	(361)	(908)
Total stockholders equity (deficit)	(108,487)	(90,742)
Total liabilities and stockholders equity (deficit)	$ 333,556	$ 336,905

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

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VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Operating Revenues:				
Telephony services	$ 214,709	$ 218,738	$ 430,352	$ 435,718
Customer equipment and shipping	5,319	8,786	13,681	16,423
	220,028	227,524	444,033	452,141
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of $4,872, $4,728, $9,629 and $9,429, respectively)	51,480	56,586	103,231	113,084
Direct cost of goods sold	16,179	18,533	36,691	40,605
Selling, general and administrative	71,327	77,931	139,378	157,323
Marketing	52,144	65,300	117,839	126,199
Depreciation and amortization	13,848	11,114	26,744	21,323
	204,978	229,464	423,883	458,534
Income (loss) from operations	15,050	(1,940)	20,150	(6,393)
Other Income (Expense):				
Interest income	60	1,021	170	2,421
Interest expense	(13,679)	(5,535)	(27,221)	(11,106)
Change in fair value of embedded derivative	1,150		14,120	
Other, net	5	52	806	(112)
	(12,464)	(4,462)	(12,125)	(8,797)
Income (loss) before income tax benefit (expense)	2,586	(6,402)	8,025	(15,190)
Income tax benefit (expense)	(301)	(480)	(469)	(653)
Net income (loss)	$ 2,285	$ (6,882)	$ 7,556	$ (15,843)
Net income (loss) per common share:				
Basic	$ 0.01	$ (0.04)	$ 0.05	$ (0.10)
Diluted	$ 0.01	$ (0.04)	$ (0.02)(1)	$ (0.10)
Weighted-average common shares outstanding:				

Basic	156,928	156,103	156,824	156,068
Diluted	218,997(1)	156,103	218,893	156,068

(1) As corrected, see Note 1.

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

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VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2009	**2008**
Cash flows from operating activities:		
Net income (loss)	$ 7,556	$ (15,843)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization and impairment charges	25,873	19,924
Amortization of intangibles	871	1,399
Change in fair value of embedded derivative	(14,120)	
Beneficial conversion on interest in kind on convertible notes		46
Amortization of discount on notes	2,729	
Accrued interest paid in-kind	9,523	
Allowance for doubtful accounts	800	(92)
Allowance for obsolete inventory	1,020	679
Amortization of debt related costs	1,515	1,655
Share-based expense	4,835	5,036
Changes in operating assets and liabilities:		
Accounts receivable	(6,158)	(5,027)
Inventory	(4,993)	4,459
Prepaid expenses and other current assets	(2,597)	(4,515)
Deferred customer acquisition costs	11,037	3,958
Due from related parties		2
Other assets	1,015	(2,563)
Accounts payable	(10,570)	15,813
Accrued expenses	9,400	(972)
Deferred revenue	(9,362)	2,716
Other liabilities	(2,750)	(2,581)
Net cash provided by (used in) operating activities	25,624	24,094
Cash flows from investing activities:		
Capital expenditures	(5,272)	(5,293)
Purchase of intangible assets		(560)
Purchase of marketable securities		(21,375)
Maturities and sales of marketable securities		77,779
Acquisition and development of software assets	(8,772)	(16,504)
Increase in restricted cash	(437)	(3,268)
Net cash provided by (used in) investing activities	(14,481)	30,779
Cash flows from financing activities:		
Principal payments on capital lease obligations	(593)	(490)
Principal payments on notes	(1,158)	
Debt related costs	(251)	
Proceeds from subscription receivable, net		9

Proceeds from directed share program, net		45
Proceeds from exercise of stock options	1	48
Net cash provided by (used in) financing activities	(2,001)	(388)
Effect of exchange rate changes on cash	724	61
Net change in cash and cash equivalents	9,866	54,546
Cash and cash equivalents, beginning of period	46,134	71,542
Cash and cash equivalents, end of period	$ 56,000	$ 126,088
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	$ 13,432	$ 9,405
Income taxes	$ 835	$ 653

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

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VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Stock Subscription Receivable	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2008	$ 158	$ 980,768	$ (5,195)	$ (1,052,861)	$ (12,704)	$ (908)	$ (90,742)
Opening adjustment-adoption of EITF 07-5		(37,884)		7,223			(30,661)
Stock option exercises	1						1
Share-based expense		4,835					4,835
Share-based award activity					(23)		(23)
Comprehensive income (loss):							
Foreign currency translation adjustment						547	547
Net income (loss)				7,556			7,556
Total comprehensive income (loss)				7,556		547	8,103
Balance at June 30, 2009	$ 159	$ 947,719	$ (5,195)	$ (1,038,082)	$ (12,727)	$ (361)	$ (108,487)

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

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. (Vonage , Company , we , our , us) is incorporated as a Delaware corporation. We are a leading, pure-play provider of broadband telephone services to residential and small office and home office customers with approximately 2.5 million subscriber lines as of June 30, 2009. While customers in the United States represented 94% of our subscriber lines at June 30, 2009, we also serve customers in Canada and the United Kingdom.

We decided to shut down our Toronto, Canada customer service center. The closing of this facility is part of our company-wide rationalization of call centers designed to cut costs. The Canadian operation, which opened in 2004, mainly handled calls from Canada and recently United Kingdom customers. The customers from these two regions will still be able to buy a full range of our products, services and receive customer support through our other customer service centers. Canadian and United Kingdom markets remain important marketplaces to our business. Approximately 200 positions were eliminated due to the shut down of our Toronto facility on July 30, 2009. See Significant Accounting Policies Facility Exit and Restructuring Costs.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows and statement of stockholders equity (deficit) for the periods presented. The results for the three and six month periods ended June 30, 2009 are not necessarily indicative of the results to be expected for the full year.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 3, 2009.

Significant Accounting Policies

Basis of Consolidation

The consolidated financial statements include the accounts of Vonage and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

On an ongoing basis, we evaluate our estimates, including the following:

- those related to the average period of service to a customer (the customer relationship period) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation. For 2008, due to the increase in churn, the customer relationship period was reduced from 60 months to 48 months. In 2009, the customer relationship period was further reduced to 44 months. The impact of this change was not material to the consolidated results of operations;

- the useful lives of property and equipment, software costs and intangible assets;

- assumptions used for the purpose of determining share-based compensation using the Black-Scholes option model (Model), and various other assumptions that we believed to be reasonable. The key inputs for this Model are stock price at valuation date, strike price for the option, the dividend yield, risk-free interest rate, life of option in years and volatility; and

- assumptions used to determine the fair value of the embedded derivative within our convertible notes using the Monte Carlo simulation model. The key inputs are maturity date, risk-free interest rate, current share price and historical volatility of our common stock.

We base our estimates on historical experience, available market information, appropriate valuation methodologies, and on various other assumptions that we believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Restricted Cash and Letters of Credit

Our credit card processors have established reserves to cover any exposure that they may have as we collect revenue in advance of providing services to our customers, which is a customary practice for companies that bill their customers in advance of providing services. As such, we provided our credit card processors with cash reserves of $22,133 and a cash collateralized letter of credit for $10,500 and $10,413 as of June 30, 2009 and December 31, 2008, respectively. We also had a cash collateralized letter of credit for $7,350 and $7,000 as of June 30, 2009 and December 31, 2008, respectively, related to lease deposits for our offices. The total amount of collateralized letters of credit was $18,000 and $17,562 at June 30, 2009 and December 31, 2008, respectively. In the aggregate, cash reserves and collateralized letters of credit of $40,133 and $39,585 were recorded as long-term restricted cash at June 30, 2009 and December 31, 2008, respectively.

Software Costs

We capitalize certain costs, such as purchased software and internally developed software that we use for customer acquisition and customer care automation tools, in accordance with Statement of Position 98-1, *Accounting for Costs of Computer Software Development or Obtained for Internal Use.* Computer software is stated at cost less accumulated amortization and the estimated useful life is three years. Total computer software was $59,651 and $53,429 at June 30, 2009 and December 31, 2008, respectively, substantially all of which were external costs. Accumulated amortization was $25,853 and $19,061 at June 30, 2009 and December 31, 2008, respectively. Amortization expense was $4,600 and $2,816, including impairment of $292 and $83, for the three months ended June 30, 2009 and 2008, respectively, and $9,343 and $4,813, including impairment of $969 and $83, for the six months ended June 30, 2009 and 2008, respectively.

Long-Lived Assets

We review the carrying values of our property and equipment for possible impairment whenever circumstances indicate the carrying amount of an asset may not be recoverable. An impairment loss is recognized to the extent the sum of the undiscounted estimated future cash flow expected to result from the use of the asset is less than the carrying value. We incurred impairment losses of $1,413 and $229, respectively, for the three months ended June 30, 2009 and 2008, and $1,460 and $316, respectively, for the six months ended June 30, 2009 and 2008. The impairment is mainly for marketing displays, network equipment and computer hardware. Impairment is recorded in the statement of operations as part of depreciation expense.

Debt Related Costs

Costs incurred in raising debt are deferred and amortized as interest expense using the effective interest method over the life of the debt. In connection with our financing transaction in November 2008, we recorded debt related costs of $12,270, which are being amortized over the life of the debt which is five years and seven years. Amortization expense related to these costs is included in interest expense in the consolidated statements of operations and was $782 and $1,516 for the three and six months ended June 30, 2009, respectively. Accumulated amortization of debt related costs was $1,994 and $478 at June 30, 2009 and December 31, 2008, respectively.

Intangible Assets

Intangible assets acquired in the settlement of litigation or by direct purchase are accounted for based upon the fair value of assets received.

Patents

In June 2006, we purchased three patents related to the compression of packetized digital signals commonly used in Voice over Internet Protocol (VoIP) technology at a cost of $5,268. In July 2006, we began amortizing the cost of these patents over their estimated useful lives of 2.7 years.

Amortization expense was $424 for the three and six months ended June 30, 2009, and $484 and $969 for the three and six months ended June 30, 2008, respectively. These patents were fully amortized as of March 31, 2009.

In October 2007, in connection with the settlement of our patent litigation with Sprint, we acquired a license to use Sprint s portfolio of Voice over Packet patents. The fair value assigned to these patents was $5,500. We began amortizing the cost of these patents in October 2007 over their patent lives of 6.6 years. Amortization expense was $206 and $413 for the three and six months ended June 30, 2009 and 2008, respectively. Annual amortization is approximately $825.

Trademark

In April 2008, in connection with the settlement of a trademark dispute, we acquired the right to use the trademark in question. The fair value assigned to the trademark was $560. This trademark is being amortized over its remaining life of 8 years. Amortization expense was $18 and $17 for the three months ended June 30, 2009 and 2008, respectively, and was $35 and $17 for the six months ended June 30, 2009 and 2008, respectively. Annual amortization is approximately $70.

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Embedded Derivative

In accordance with Emerging Issues Task Force (EITF) Issue No. 07-5, *Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity s Own Stock* (EITF 07-5), which we adopted on January 1, 2009, our $18,000, 20% senior secured third lien notes due 2015 (the Convertible Notes) contain an embedded derivative that requires separate valuation from the Convertible Notes. We recognize this derivative as a liability in our consolidated balance sheet at its estimated fair value each period, and recognize any change in its estimated fair value in our statement of operations in the period of change. We estimate the fair value of the embedded derivative using available market information and appropriate valuation methodologies (see Note 3).

Fair Value of Financial Instruments

Effective January 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157). This standard establishes a framework for measuring fair value and expands disclosure about fair value measurements. We did not elect fair value accounting for any assets and liabilities allowed by SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159).

SFAS No. 157 defines fair value as the amount that would be received for an asset or paid to transfer a liability (i.e., an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS No. 157 also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. SFAS No. 157 describes the following three levels of inputs that may be used:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets and liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2: Observable prices that are based on inputs not quoted on active markets but corroborated by market data.

Level 3: Unobservable inputs when there is little or no market data available, thereby requiring an entity to develop its own assumptions. The fair value hierarchy gives the lowest priority to Level 3 inputs.

Currently, SFAS No. 157 applies to the derivative that is embedded within our Convertible Notes (see Note 3), which is included in long term liabilities in our consolidated balance sheet. The embedded derivative was valued using the Monte Carlo simulation model. The key inputs in the model are as follows:

	June 30, 2009	January 1, 2009
Maturity date	October 31, 2015	October 31, 2015
Risk-free interest rate	3.00%	2.24%
Price of common stock	$ 0.38	$ 0.66
Volatility	90%	87%

The embedded derivative within our Convertible Notes is measured at fair value on a recurring basis using significant unobservable inputs (Level 3). The amount of total gain in earnings for the six months ended June 30, 2009 is as follows:

Liabilities:	Derivatives
Beginning balance	$ 32,720
Total unrealized gain in earnings	$ (14,120)
Ending balance	$ 18,600

Fair Value of Other Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management s best estimates of interest rates that would be available for similar debt obligations at June 30, 2009. We believe the fair value of our debt at June 30, 2009 was approximately the same as its carrying amount as market conditions, including available interest rates, credit spread relative to our credit rating, and illiquidity, remain relatively unchanged from the issuance date of our debt.

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Earnings per Share (Corrected)

Net income (loss) per share has been computed according to SFAS No. 128, *Earnings per Share*, which requires a dual presentation of basic and diluted earnings per share (EPS). Basic EPS represents net income (loss) divided by the weighted average number of common shares outstanding during a reported period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including warrants, stock options and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, and the Convertible Notes, were exercised or converted into common stock. The dilutive effect of outstanding warrants, stock options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services. The dilutive effect of the Convertible Notes is reflected in diluted earnings per share using the if-converted method.

Subsequent to the issuance of our Form 10-Q for the quarter ended June 30, 2009, we determined we had made an error in the computation of diluted net income per share whereby we did not take into account the change in the fair value of the embedded derivative related to the conversion option in the Convertible Notes. See also Embedded Derivative on page 8. This error resulted in presentation of diluted net income, rather than diluted net loss, per share for the six months ended June 30, 2009. In accordance with Staff Accounting Bulletin (SAB) No. 99, *Materiality*, we evaluated the materiality of the error from qualitative and quantitative perspectives, and concluded that the error was immaterial to the financial statements for the three and six months ended June 30, 2009.

The following tables reflects the computation of basic net income per share and the impact of the correction to the computation of diluted net income (loss) per share for the three and six months ended June 30, 2009.

	As Originally Reported	As Corrected	Effect of Correction
	Three Months Ended June 30, 2009		
Numerator			
Numerator for basic earnings per share-net income	$ 2,285	$ 2,285	$
Add: interest savings on assumed conversion of Convertible Notes		1,178	1,178
Less: change in fair value of embedded derivative		(1,150)	(1,150)
Numerator for diluted earnings per share	$ 2,285	$ 2,313	$ 28
Denominator			
Basic weighted average common shares outstanding	156,928	156,928	
Dilutive effect of Convertible Notes		62,069	62,069
Diluted weighted average common shares outstanding	156,928	218,997	62,069
Basic net income per share			
Basic net income per share	$ 0.01	$ 0.01	$
Diluted net income per share			

Diluted net income per share	$	0.01	$	0.01	$

	As Originally Reported	As Corrected	Effect of Correction
	Six Months Ended June 30, 2009		
Numerator			
Numerator for basic earnings per share-net income	$ 7,556	$ 7,556	$
Add: interest savings on assumed conversion of Convertible Notes	2,420	2,420	
Less: change in fair value of embedded derivative		(14,120)	(14,120)
Numerator for diluted earnings per share	$ 9,976	$ (4,144)	$ (14,120)
Denominator			
Basic weighted average common shares outstanding	156,824	156,824	
Dilutive effect of Convertible Notes	62,069	62,069	
Diluted weighted average common shares outstanding	218,893	218,893	
Basic net income per share			
Basic net income per share	$ 0.05	$ 0.05	$
Diluted net income (loss) per share			
Diluted net income (loss) per share	$ 0.05	$ (0.02)	$ (0.07)

For the three and six months ended June 30, 2009 and 2008, the following table reflects the correction of the items that were excluded from the calculation of diluted net income (loss) per share because of their anti-dilutive effects:

	Three Months Ended June 30,				Six Months Ended June 30,	
	2009	2009	2009	2008	2009	2008
	As Originally Reported	As Corrected	Effect of Correction			
Common stock warrants	514	514		3,085	514	3,085
Convertible notes (1)				17,824		17,824
Convertible Notes	62,069		(62,069)			
Restricted stock units	3,509	3,509		3,938	3,509	3,938
Employee stock options	26,390	26,390		21,832	26,390	21,832

Third Quarter	$ 6.28	$ 3.47	$ 5.18	$ 3.40
Fourth Quarter	$ 4.04	$ 1.91	$ 9.53	$ 4.18

As of December 31, 2008, there were approximately 2,200 stockholders of record of our common stock. We derived the number of stockholders of record by reviewing the listing of outstanding common stock recorded by our transfer agent as of December 31, 2008.

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STOCK PERFORMANCE GRAPH

The graph set forth below compares the cumulative total stockholder return on our common stock between June 2, 2006 (the date our common stock commenced trading on The NASDAQ Global Market) and December 31, 2008, versus the cumulative total return of the NASDAQ Composite Index and Russell Microcap Index over the same period. This graph assumes the investment of $100,000 at the closing price of the market on June 2, 2006 in our common stock, the NASDAQ Composite Index and the Russell Microcap Index, and assumes the reinvestment of dividends, if any. We have never paid dividends on our common stock and have no present plans to do so.

Since there is no published industry or line-of-business index for our business reflective of the performance the Company, nor do we believe we can reasonably identify a peer group, we measure our performance with issuers of similar market capitalization. We selected the Russell Microcap Index because it measures the performance of a broad range of companies with lower market capitalization than those companies included in the S&P 500 Index, we have a low market capitalization, and our common stock was first selected for inclusion in this index in June 2008.

The comparisons shown in the graph below are based upon historical data. We caution that the stock price performance shown in the graph below is not necessarily indicative of, nor is it intended to forecast, the potential future performance of our common stock.

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The preceding Stock Performance Graph is not deemed filed with the Securities and Exchange Commission and shall not be incorporated by reference in any of our filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

DIVIDEND POLICY

Since our inception, we have never declared or paid any cash dividends. We currently expect to retain earnings for use in the operation and expansion of our business, and therefore do not anticipate paying any cash dividends in the foreseeable future.

EQUITY COMPENSATION PLANS

The information required by this item regarding equity compensation plans is set forth in Part III, Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters of this Annual Report on Form 10-K.

UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Unregistered Sales of Equity Securities during the Three Months Ended December 31, 2008

There were no unregistered sales of equity securities during the three months ended December 31, 2008.

Use of Proceeds from Sale of Registered Equity Securities

On June 2, 2006, our Registration Statement on Form S-1, as amended (Reg. Nos. 333-131764) was declared effective in connection with the initial public offering of our common stock, pursuant to which we registered and directly sold an aggregate of 3,500,000 shares of our common stock at a price to the public of $6.00 per share. The offering closed on June 6, 2006, and, as a result, we received net proceeds of approximately $17.87 million (after underwriters discounts and commissions of approximately $1.47 million and additional offering-related costs of approximately $1.66 million). The managing underwriter of the offering was ThinkEquity Partners LLC. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates.

We are using, or expect to use, the net proceeds of the offering principally to fund further development and expansion of our products and product candidates, in particular our nanomaterial and ultrasound-related medical product candidates, and for general working capital purposes. We may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business. We have no present commitments or binding agreements to enter into any acquisitions or investments. Pending these uses, we intend to continue to invest the net proceeds of our initial public offering in short-term, investment-grade interest-bearing securities or guaranteed obligations of the U.S. government.

PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

None during the fourth quarter of 2008.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and the accompanying notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included at Part II, Item 7 in this Annual Report on Form 10-K. The selected data in this section is not intended to replace the consolidated financial statements.

(In thousands, except share and per share data)	2004	2005	Years Ended December 31, 2006	2007	2008
Consolidated Statements of Operations Data:					
Revenues:					
Technology Division Revenues	$ 13,835	$ 15,380	$ 18,788	$ 23,356	$ 26,839
Products sales and licensing revenues	8,752	1,074	4,758	10,326	10,059
Total revenues	22,587	16,454	23,546	33,682	36,898
Cost of revenues					
Technology development division costs	10,985	12,552	14,141	16,546	17,626
Product sales and licensing costs	2,881	410	2,221	4,820	5,231
Total cost of revenues	13,866	12,962	16,362	21,366	22,857
Gross profit	8,721	3,492	7,184	12,316	14,041
Operating expense	4,190	6,004	17,150	20,570	21,473
Operating income (loss)	4,531	(2,512)	(9,966)	(8,254)	(7,432)
Other income (expense)	(257)	2	26	33	1,336
Interest income (expense), net	(90)	(41)	516	372	(190)
Income (loss) before income taxes	4,184	(2,551)	(9,424)	(7,850)	(6,286)
Income tax expense (benefit)	128	(557)	13		
Net income (loss)	$ 4,056	$ (1,994)	$ (9,437)	$ (7,850)	(6,286)
Net income (loss) per common share:					
Basic	$ 1.40	$ (0.53)	$ (1.14)	$ (0.77)	$ (0.57)
Diluted	$ 1.14	$ (0.53)	$ (1.14)	$ (0.77)	$ (0.57)
Weighted-average number of shares used in per share calculations:					
Basic	2,903,022	3,735,811	8,283,074	10,219,711	10,974,010
Diluted	3,561,788	3,735,811	8,283,074	10,219,711	10,974,010

	2004	2005	As of December 31, 2006	2007	2008
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 610	$ 12,515	$ 17,867	$ 12,047	$ 15,519
Working capital (deficit)	257	11,843	19,283	14,115	14,992
Total assets	7,747	24,134	35,217	32,549	34,017
Total current liabilities	4,474	6,993	7,560	10,053	11,129
Total debt	303	5,431	5,328	5,000	10,000
Stockholder s equity	2,167	10,854	22,075	17,137	14,316

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We reacquired our Luna Technologies division in September 2005, having previously established Luna Technologies, Inc. in July 1998 and funding its growth by raising venture capital. Such financing activities diluted our equity ownership in Luna Technologies, Inc. to as little as approximately 7% during our holding period and to approximately 10% prior to September 2005. We purchased all of the stock of Luna Technologies, Inc. that we did not own in exchange for shares of our common stock in September 2005.

Please see Critical Accounting Policies and Estimates included as part of Part II, Item 7 of this Annual Report on Form 10-K for further discussion of key accounting changes which occurred during the years covered in the above table. Additional information regarding business combinations and dispositions for the relevant periods above may be found in the notes accompanying our consolidated financial statements at Part II, Item 8 of this Annual Report on Form 10-K.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this report. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under Risk factors and elsewhere in this report.

Overview

We research, develop and commercialize innovative technologies in two primary areas of focus: test & measurement, sensing, and instrumentation products and health care products. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative products to market. We identify technologies that can fulfill large and unmet market needs and then take these technologies from the applied research stage through commercialization. Although revenues from product sales currently represent less than half of our total revenues, we continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues. In addition, we anticipate that, these revenues will reflect a broader and more diversified mix of products as we develop and commercialize new products.

We have developed a disciplined and integrated process to accelerate the development and commercialization of innovative technologies. Our business model employs a market-driven approach and provides the infrastructure, resources and know-how throughout the process of developing and commercializing new products. To manage a diverse set of products effectively across a range of development stages, we are organized into two main groups: our Technology Development Division and our Products Division. These groups work together through all product development stages, including:

- Searching for emerging technologies based on market needs;
- Conducting applied research;
- Developing and commercializing innovative products; and
- Applying proven technologies and products to new market opportunities.

Our annual revenues were $23.5 million in 2006, $33.7 million in 2007, and $36.9 million in 2008. We generate revenues through technology development services provided under contractual arrangements, product sales and license fees. Historically, our technology development revenues have accounted for a large proportion of our total revenues, and we expect that they will continue to represent a significant portion of our total revenues for the foreseeable future. Our technology development revenues grew from $18.8 million in 2006, to $23.4 million in 2007 and $26.8 million in 2008. We have historically had a backlog of contracts for which work has been scheduled, but for which a specified portion of work has not yet been completed. We define backlog as the dollar amount of obligations payable to us under negotiated contracts upon completion of a specified portion of work that has not yet been completed, exclusive of revenues previously recognized for work already performed under these contracts, if any. Total backlog includes funded backlog (the amount for which money has been directly authorized by the U.S. Congress and for which a purchase order has been received by a commercial customer) and unfunded backlog (firm orders for which funding has not been appropriated). Indefinite delivery and quantity contracts and unexercised options are not reported in total backlog. The approximate value of our backlog was $29.4 million at December 31, 2008.

Revenues from product sales currently represent a smaller proportion of our total revenues, and, historically, we have derived most of these revenues from the sales of our sensing systems and products that make use of light-transmitting optical fibers, or fiber optics. Although we have been successful in licensing certain technology in past years, we do not expect license revenues to represent a significant portion of future revenues; however, over time we do intend to gradually increase such revenues. In the near term, we expect revenues from product sales to be primarily in areas associated with our fiber optic instrumentation and test and measurement platforms. We also expect to increase our investments in product development and commercialization, which we anticipate

will lead to increased product sales growth. In the long term, we expect that revenues from product sales will represent a larger proportion of our total revenues and that as we develop and commercialize new products, these revenues will reflect a broader and more diversified mix of products.

We incurred consolidated net losses of approximately $9.4 million, $7.9 million, and $6.3 million for the years ended December 31, 2006, 2007, and 2008, respectively. We expect to continue to incur significant expenses as we expand our business, including increased expenses for research and development, sales and marketing, and manufacturing capability. We may also grow our business in part through acquisitions of additional companies and complementary technologies, which could cause us to incur transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we may likely continue to incur losses for the foreseeable future, and these losses could be substantial.

In June 2007, we entered into an intellectual property licensing, development, and supply agreement with Intuitive Surgical Inc., or Intuitive. Under the terms of the multi-year agreement, we will develop and supply our fiber optic-based shape sensing and position tracking system for integration into Intuitive s products, including the da Vinci® Surgical System. Pursuant to the agreement, Intuitive agreed to pay us certain fees including an up-front license fee, development fees payable in quarterly installments over the initial year-and-a half period following the date of the agreement, and certain other fees, subject to certain termination rights by Intuitive and other rights of repayment or reduction. Such fees do not include the minimum purchase requirements of Intuitive, which are subject to the successful completion of the development criteria and certain other terms and conditions.

During the three months ended December 31, 2008, we began to experience the impact of the general downtown affecting the United States and global economies. Specifically, revenue from the sale of our products during the fourth quarter of 2008 declined substantially as compared to both the immediately preceding quarter and the same quarter in 2007. We experienced declines in both the number of units sold as well as a in the average price per unit sold, and we cannot be certain that such declines will not continue or worsen as the state of the U.S. and global economy remains uncertain.

Description of Our Revenues, Costs and Expenses

Revenues

We generate revenues from technology development, product sales and license payments. We derive technology development revenues from providing research and development services to third parties, including government entities, academic institutions and corporations, and from achieving milestones established by some of these contracts and in collaboration agreements. In general, we complete contracted research over periods ranging from six months to three years, and recognize these revenues over the life of the contract as costs are incurred or upon the achievement of certain milestones built into the contracts. Our product revenues reflect amounts that we receive from sales of our products or development of products for third parties and currently represent approximately 27% of our total revenues. Our license revenues are comprised of up-front license fees paid to us in connection with licenses or sublicenses of certain patents and other intellectual property as well as royalties, which currently represent an immaterial proportion of our license revenues.

Cost of Revenues

Cost of revenues associated with technology development revenues consists of costs associated with performing the related research activities, including direct labor, amounts paid to subcontractors and overhead allocated to technology development activities.

Cost of revenues associated with product sales and license revenues consists of license fees for use of certain technologies; product manufacturing costs including all direct material and direct labor costs; amounts paid to our contract manufacturers; manufacturing, shipping and handling; provisions for product warranty; and inventory obsolescence, as well as overhead allocated to these activities.

Operating Expense

Operating expense consists of selling, general and administrative expenses, as well as expenses related to research and development, depreciation of fixed assets and amortization of intangible assets. These expenses also include: compensation for employees in executive and operational functions including certain non-cash charges related to expenses from option grants; facilities costs; professional fees; salaries, commissions, travel expense and related benefits of personnel engaged in sales, product management and marketing activities; costs of marketing programs and promotional materials; salaries, bonuses and related benefits of personnel engaged in our own research and development beyond the scope and activities of our Technology Development Division; product development activities not provided under contracts with third parties; and overhead costs related to these activities.

Interest Income/Expense

On May 21, 2008, we canceled our senior secured revolving credit facility with First National Bank, and entered into a new $10 million debt facility with Silicon Valley Bank. At December 31, 2008, a $5.0 million term loan was outstanding under this new facility. Interest expense includes interest accrued on the outstanding aggregate principal of the senior convertible promissory notes issued to Carilion Clinic on December 30, 2005 and interest payable on the Silicon Valley Bank debt term loan.

Interest income includes amounts earned on our cash deposits with financial institutions. During 2007 and 2008, we invested the proceeds of the Carilion financing transactions and the net proceeds from our initial public offering in a money market account, and we draw from that account as needed to fund ongoing operations. We also invested the proceeds from the Silicon Valley Bank debt facility in a money market account beginning with our initial draw in May 2008.

Critical Accounting Policies and Estimates

Technology Development Revenues

We recognize revenue when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred, and collectibility of the contract price is considered probable and can be reasonably estimated. Revenue is earned under cost reimbursable, time and materials and fixed price contracts. Direct contract costs are expensed as incurred.

Under cost reimbursable contracts, we are reimbursed for allowable costs and paid a fixed fee. Revenues on cost reimbursable contracts are recognized as costs are incurred plus an estimate of applicable fees earned. We consider fixed fees under cost reimbursable contracts to be earned in proportion to the allowable costs incurred in performance of the contract.

Revenue on time and materials contracts are recognized based on direct labor hours expended at contract billing rates and adding other billable direct costs.

Fixed price contracts may include either a product delivery or specific service performance throughout a period. For fixed price contracts that are based on the proportionate performance method and involve a specified number of deliverables, we recognize revenue based on the proportion of the cost of the deliverables compared to the cost of all deliverables included in the contract. For fixed price contracts that provide for the development and delivery of a specific prototype or product, revenues are recognized on under the percentage of completion method in accordance with Statement of Position (SOP) 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

Our contracts with agencies of the government are subject to periodic funding by the respective contracting agency. Funding for a contract may be provided in full at inception of the contract or ratably throughout the

contract as the services are provided. In evaluating the probability of funding for purposes of assessing collectibility of the contract price, we consider our previous experience with our customers, communication with our customers regarding funding status, and our knowledge of available funding for the contract or program. If funding is not assessed as probable, revenue recognition is deferred until realization is deemed probable.

Contract revenue recognition inherently involves estimation, including the contemplated level of effort to accomplish the tasks under the contract, the cost of the effort, and an ongoing assessment of progress toward completing the contract. From time to time, as part of normal management processes, facts may change, causing revisions to estimated total costs or revenues expected. The cumulative impact of any revisions to estimates and the full impact of anticipated losses on any type of contract are recognized in the period in which they become known.

The underlying bases for estimating our contract research revenues are measurable expenses such as labor, subcontractor costs and materials, the cost data of which is updated on a regular basis for purposes of preparing our cost estimates. Our research contracts generally have a period of performance of six to 18 months. Accordingly, our estimates of contract costs have historically been consistent with actual results. Revisions in these estimates between accounting periods to reflect changing facts and circumstances have not had a material impact on our operating results, and we do not expect future changes in these estimates to be material.

Whether certain costs under government contracts are allowable is subject to audit by the government. Certain indirect costs are charged to contracts using provisional or estimated indirect rates, which are subject to later revision based on government audits of those costs. Management is of the opinion that costs subsequently disallowed, if any, would not be significant.

Product Revenues

We recognize revenue relating to our products when pervasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured. Pursuant to the adoption of Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables,* we evaluate product sales that are a part of multiple-element revenue arrangements to determine whether separate units of accounting exist, and follow appropriate revenue recognition policies for each separate unit. Elements are considered separate units of accounting provided that (i) the delivered items has stand-alone value to the customer; (ii) there is objective and reliable evidence of the fair value of the undelivered item; (iii) if a general right of return exists relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially within our control. In certain product sales arrangements, we offer products bundled together at a discount. We allocate the overall contract consideration among the separate units of accounting based upon their fair values, with the amount allocated to the delivered item being limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions. We base the fair value of the undelivered items upon the normal pricing practice for those items, which is generally the price when sold separately.

For products containing software that is considered more than an incidental component, we consider the requirements of SOP 97-2, *Software Revenue Recognition.* We have concluded that our product sales do not include multiple deliverable elements, as we do not offer post contract customer support, technical services or upgrades and enhancements, or other related services, which would require deferring recognition of revenue relating to the product, absent the existence of fair value for any undelivered elements.

Income Taxes

We estimate our tax liability through calculating our current tax liability, together with assessing temporary differences resulting from the different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which we record on our balance sheet. Management then assesses the likelihood that deferred tax assets will be recovered in future periods. In assessing the need for a valuation

allowance against the net deferred tax asset, management considers factors such as future reversals of existing taxable temporary difference, taxable income in prior carry back years, whether carry back is permitted under the tax law, tax planning strategies, and estimated future taxable income exclusive of reversing temporary differences and carry forwards. To the extent that we cannot conclude that it is more likely than not that the benefit of such assets will be realized, we establish a valuation allowance to reduce their net carrying value.

As we assess our projections of future taxable income or other factors that may impact our ability to generate taxable income in future periods, our estimate of the required valuation allowance may change, which could have a material impact on future earnings or losses.

Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 has not had a material impact on our results of operation since our adoption of this guidance in 2007.

While it is often difficult to predict the final outcome or timing of the resolution of any particular tax matter, we establish a liability at the time we determine it is probable we will be required to pay additional taxes related to certain matters. These liabilities are recorded in the line item Accrued Liabilities in our consolidated balance sheets. We adjust such provision, including any impact on the related interest and penalties, in light of changing facts and circumstances, such as the progress of a tax audit. A number of years may elapse before a particular matter for which we have established a liability is audited and finally resolved. The number of years with open tax audits varies depending on the tax jurisdiction. Settlement of any particular issue would usually require the use of cash. We recognize favorable resolutions of tax matters for which we have previously established liabilities as a reduction to our income tax expense when the amounts involved become known.

Due to differences between federal or state tax law, and accounting principles generally accepted in the United States of America, or GAAP, certain items are included in the tax return at different times than when these items are reflected in the consolidated financial statements. Therefore, the annual tax rate reflected in our consolidated financial statements is different than that reported in our tax return. Some of these differences are permanent, such as expenses that are not deductible in our tax return. Some differences, such as depreciation expense reverse over time and create deferred tax assets and liabilities. The tax rates used to determine deferred tax assets or liabilities are the enacted tax rates in effect for the year in which the differences are expected to reverse. Based on the evaluation of all available information, we recognize future tax benefits, such as net operating loss carry forwards, to the extent that realizing these benefits is considered more likely than not. A substantial portion of our net deferred tax asset has been reserved until such time that we generate substantial taxable income from operations or other tax planning strategies that will enable us to fully benefit from this asset.

Stock-Based Compensation

Effective January 1, 2006, we adopted SFAS No. 123R, *Share Based Payment* (SFAS No. 123R) using the modified prospective transition method. Under this transition method, our financial statements for periods prior to January 1, 2006 were not restated. However, we incur compensation expense for new awards and awards modified, repurchased or cancelled after January 1, 2006. This compensation expense is computed using the fair value of the stock option as determined by an option pricing model, the Black-Scholes valuation model. We amortize stock-based compensation for such awards on a straight-line method over the related service period of the awards taking into account the effects of the employees expected exercise and post-vesting employment termination behavior. To compute the volatility used in this model for options granted after November 2008, we use the lifetime volatility of our common stock, because the stock has been publicly traded for over two years

and thus provides sufficient data to determine volatility. To compute the volatility used in this model for options granted prior to November 2008, we used data from comparable companies.

Under the modified prospective method, we recognize compensation cost in our financial statements for all awards granted after January 1, 2006 and for all awards outstanding as of January 1, 2006 for which the requisite service had not been rendered as of the date of adoption. We measure the amount of compensation cost based on the fair value of the underlying equity award on the date of grant. We recognize compensation cost over the period that an employee provides service in exchange for the award. As of December 31, 2008, total compensation expense not yet recognized related to unvested options is approximately $6.2 million.

Goodwill and Other Intangible Assets

At December 31, 2008, we had $418,000 in goodwill relating to our acquisition of Luna Technologies in September 2005. We account for goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires goodwill and certain intangible assets to no longer be amortized. In addition, goodwill is tested for impairment at the reporting unit level and intangible assets deemed to have an indefinite life and other intangibles are tested for impairment at least annually, or more frequently if impairment indicators arise. We test for impairment of goodwill by preparing a discounted future net cash flow analysis.

Discounted net future cash flows are an estimate of the fair value of the reporting unit. In preparing this projection, we make a number of assumptions, which include, without limitation, future sales volume levels, price levels, rates of increase in operating expenses, as well as assumptions concerning the timely completion of certain product development activities. If our projection of discounted future cash flows is in excess of the carrying value of the recorded asset, no impairment is reported. If the carrying value of the asset exceeds the projected discounted net cash flows, an impairment charge is recorded. The amount of the impairment charge is the excess of the carrying value of the asset over discounted net cash flows.

We account for patents in accordance with SFAS No. 144, *Accounting for Disposal or Impairment of Long-Lived Assets*. We amortize our patents over their estimated useful life of five years, and analyze them periodically to determine whether their carrying value has been impaired. At the end of December 31, 2008 and 2007, respectively, no patents were written down due to any impairment in value.

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Results of Operations

The following table shows information derived from our consolidated statements of operations expressed as a percentage of revenues for the periods presented.

	Year ended December 31,		
	2006	**2007**	**2008**
Revenues;			
Technology development revenues	79.8%	69.3%	72.7%
Product revenues	20.2%	30.7%	27.3%
Total revenues	100.0%	100.0%	100.0%
Cost of Revenues:			
Technology development costs	60.1%	49.1%	47.8%
Product costs	9.4%	14.3%	14.2%
Total cost of revenues	69.4%	63.4%	61.9%
Gross Profit	30.5%	36.6%	38.1%
Operating Expense	72.8%	61.1%	57.8%
Operating Loss	(42.3%)	(24.5%)	(19.8%)
Total Other Income, net	2.3%	1.2%	2.7%
Loss Before Income Taxes	(40.0%)	(23.3%)	(17.0%)
Income Tax Expense	0.1%	0.0%	0.0%
Net Loss	(40.1%)	(23.3%)	(17.0%)

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Revenues

Total revenues for the year ended December 31, 2008 were $36.9 million, representing an increase of $3.2 million, or 9.6%, over revenues of $33.7 million for the year ended December 31, 2007. The increase was comprised of a $3.5 million, or 15%, increase in technology development revenue and a $0.3 million, or 2.6%, decrease in product and license revenue.

Technology development revenue grew in 2008 due to additional contract awards. A greater proportion of our labor costs were spent generating revenue in 2008 than in 2007, which translated to increased revenue. Direct labor applied to billable contract activity increased from 72% of total technology development labor dollars for the year ended December 31, 2007 to 76% for the year ended December 31, 2008. We believe that we improved the efficiency of our technology development labor during the year ended December 31, 2008.

Product sales, product development, and licensing revenues for the years ended December 31, 2008 and 2007 were $10.1 million and $10.3 million, respectively, representing a 2.6% decrease, or $0.2 million, between these two years. Product development activities included product development work for our arrangement with Intuitive Surgical, Inc., and various arrangements with governmental entities.

Revenues relating to product development activities decreased to $3.3 million during the year ended December 31, 2008, or 21% from $4.2 million during the year ended December 31, 2007. We attribute this decrease predominantly to changes in our estimates for the level of effort required to attain milestones in certain product development contracts. When estimated costs to complete a contract increase, we reduce our revenues previously recognized, pursuant to the provisions of SOP 81-1, *Accounting for the Performance of Construction-Type and Certain Production-Type Contracts*. We reduced revenues on a cumulative basis by approximately $0.3 million for the three months ended March 31, 2008 and by approximately $0.6 million for the three months ended December 31, 2008 due to such changes in estimates.

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The decline in product development revenue was offset by an increase in the revenue realized from product sales for the year ended December 31, 2008. Product sales revenue increased to $6.8 million during the year ended December 31, 2008, or 10%, from $6.1 million for the year ended December 31, 2007. However, the general deterioration of the global economy began to impact our product sales during the three month ended December 31, 2008.

Revenue from product sales for the nine months ended September 30, 2008 was $5.4 million, an increase of $1.7 million, or 46%, compared to product revenue for the nine months ended September 30, 2007 of $3.7 million. However, revenue from the sale of our products for the three months ended December 31, 2008 decreased $1.0 million, or 83%, to $1.2 million for the three months ended December 31, 2008, as compared to $2.2 million for the three months ended December 31, 2007. The number of units sold on which we recognized revenue declined by 33% to 13 during the three months ended December 31, 2008 from 21 during the three months ended December 31, 2007.

Cost of Revenues

Cost of revenues increased 7% to $22.9 million for the year ended December 31, 2008 from $21.4 million for the year ended December 31, 2007. Cost of revenues for technology development increased $1.1 million, or 7%, to $17.6 million for the year ended December 31, 2008 from $16.5 million for the year ended December 31, 2007. This increase primarily resulted from the addition of personnel during 2008 to fulfill our awarded research contracts, a higher proportion of time expended on direct labor, and other direct costs associated with these contracts.

Product and license cost of revenues increased $0.4 million, or 9%, largely attributable to the increases of cost of goods relating to the sale of products.

Operating Expense

Operating expense increased to $21.3 million for the year ended December 31, 2008 from $20.6 million for the year ended December 31, 2007, an increase of $0.7 million, or 3%, over 2007. The increase in operating expense was driven primarily by two factors in 2008; an increase in litigation expenses, and an increase in share-based compensation expenses.

Expenses relating to litigation for the year ended December 31, 2008 were approximately $2.4 million, an increase of $1.1 million, or 85%, over litigation expenses for the year ended December 31, 2007 of $1.3 million. The expense increase is attributable to on-going corporate litigation almost entirely with respect to our dispute with Hansen Medical.

Expenses relating to share-based compensation were $2.9 million for the year ended December 31, 2008, an increase of $0.5 million, or 21%, over share-based compensation expenses of $2.4 million for the year ended December 31, 2007. The increase in share-based compensation was driven by an increase in the expense relating to options issued to employees, accounted for under the provisions of SFAS 123R. Expenses relating to these options increased due to an increase in the number of options granted during 2008.

Other Income (Expense)

Other income was $1.0 million for the year ended December 31, 2008 compared to $0.4 million for the year ended December 31, 2007, an increase of $0.6 million in other income items, or approximately 150%. This increase was due primarily to the following transactions occurring during the year ended December 31, 2008: receipt of net proceeds of a legal settlement, and recognition of income from partial satisfaction of the terms of a grant from the City of Danville.

On July 23, 2008, we settled litigation at mediation with our former auditing and accounting firm in connection with the firm s auditing and opining on the accuracy of several years of our consolidated financial statements in preparation for our registration with the Securities and Exchange Commission and our initial public offering of securities. The settlement of this matter at mediation was without any admission of liability, or adjudication of fact or law, and the material terms included payment to us. We recognized $0.5 million in other income related to this settlement, which is shown net of related legal expenses.

In March 2004, we received a $900,000 grant from the City of Danville, Virginia to be used for the expansion of economic and commercial growth within the City. Specifically, $450,000 of the grant was to offset certain capital expenditures for leasehold improvements being made at our Danville facility, and the remaining $450,000 for our creation of new jobs. Accordingly, we deferred the full $900,000 amount of the grant as a liability on our balance sheet until we were able to satisfy the grant conditions. In December 2008 we received a determination letter from the City of Danville indicating that we had met 100% of the conditions of the grant relating to job creation and 29% of the conditions of the grant relating to capital expenditures. As a result, we recognized $668,000 of the grant proceeds as other income for the year ended December 31, 2008 and correspondingly reduced the deferred liability of $900,000 on our balance sheet.

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Revenues

Total revenues for the year ended December 31, 2007 were $33.7 million, representing an increase of $10.1 million, or 43%, over revenues of $23.5 million for the year ended December 31, 2006. The year over year increase was comprised of a $4.6 million, or 24%, increase in technology development revenue and a $5.6 million, or 117%, increase in product and license revenue.

Technology development revenue grew primarily due to hiring of additional personnel throughout 2007, resulting in increased billable activities performed under our research contracts.

Total product and licensing revenues were $10.3 million for the year ended December 31, 2007, representing a 117% increase over product and licensing revenues of $4.8 million for the year ended December 31, 2006. Approximately $5.9 million of the 2007 product and license revenues related to product sales of our Products division. Product and license revenues for the year ended December 31, 2007 also included $0.2 million in sales of medical products and $4.2 million in contracted product development activities, which included product development work for the arrangement with Intuitive Surgical, Inc. and various arrangements with government entities. Contracted product development activities for the year ended December 31, 2006 were $625,000.

Cost of Revenues

Cost of revenues increased 31% to $21.4 million for the year ended December 31, 2007 from $16.4 million for the year ended December 31, 2006. Cost of revenues for technology development increased $2.4 million, or 17%, to $16.5 million for the year ended December 31, 2007 from $14.1 million for the year ended December 31, 2006. This increase primarily resulted from the addition of personnel during 2007 to fulfill our awarded research contracts, a higher proportion of time expended on direct labor, and other direct costs associated with these contracts.

Product and license cost of revenues increased $2.6 million, or 117%, consistent with the product and license revenue growth of 117%, primarily attributable to increased costs associated with an increase in the number of units sold.

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Operating Expense

Operating expense increased to $20.6 million for the year ended December 31, 2007 from $17.2 million for the year ended December 31, 2006. The increase in operating expense was primarily attributable to increased spending in research and development activities, principally related to research concerning carbon nanomaterials and their potential application in diagnostic imaging, development of our medical products, increased recognition of expense for share-based compensation, and increases in personnel, professional fees and other costs. These increased costs were incurred in support of our strategy to achieve long term growth through the commercialization of innovative products utilizing our proprietary and licensed technologies. We expect our operating expenses to continue to increase, at a lesser rate of growth, as we continue to invest in new product development and increase product sales.

Other Income/(Expense)

Other income was $400,000 for the year ended December 31, 2007 compared to $500,000 for the year ended December 31, 2006. The decline is attributable to reduced cash deposits from 2006 to 2007, resulting in lower interest income earned on deposits.

Quarterly Results

The following table sets forth our unaudited historical revenues, operating income and net loss by quarter during 2007 and 2008:

	Fiscal Year 2007				Fiscal Year 2008			
(Dollars in thousands, except loss per share)	**March 31, 2007**	**June 30, 2007**	**September 30, 2007**	**December 31, 2007**	**March 31, 2008**	**June 30, 2008**	**September 30, 2008**	**December 31, 2008**
Revenues:								
Technology development	$ 5,287	$ 5,852	$ 5,952	$ 6,265	$ 6,602	$ 6,947	$ 7,247	$ 6,043
Product and license	1,784	2,003	2,867	3,671	2,318	2,931	3,457	1,354
Total revenues	7,071	7,855	8,820	9,936	8,920	9,878	10,704	7,397
Operating loss	$ (2,795)	$ (2,291)	$ (1,982)	$ (1,186)	$ (1,876)	$ (1,765)	$ (1,105)	$ (2,544)
Net loss	$ (2,682)	$ (2,178)	$ (1,838)	$ (1,151)	$ (1,852)	$ (1,798)	$ (474)	$ (2,161)
Basic and fully diluted loss per share	$ (0.27)	$ (0.21)	$ (0.18)	$ (0.11)	$ (0.17)	$ (0.16)	$ (0.04)	$ (0.19)

Liquidity and Capital Resources

Prior to August 2005, our primary source of liquidity had been cash provided by operations and divestitures of certain assets and businesses. In August 2005, we completed our first outside equity financing and raised $7.0 million through an equity investment by Carilion Clinic (formerly Carilion Health System). Carilion Clinic invested an additional $8.0 million in December 2005 in the form of $5.0 million aggregate principal amount of senior convertible promissory notes and $3.0 million in additional equity.

On June 2, 2006, the effective date of our initial public offering, we sold 3,500,000 shares of common stock at $6.00 per share, resulting in gross proceeds of $21.0 million. In connection with this offering, we paid $1.47 million in underwriting discounts and commissions and incurred other offering expenses of approximately $1.66 million. The net proceeds from the offering were approximately $17.87 million.

Our principal uses of cash have been to fund our development of medical products and carbon nanomaterials, and our overall expansion, including facilities, personnel, working capital and other capital expenditures.

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On May 21, 2008, we canceled our previous line of credit agreement with First National Bank, and entered into a $10 million maximum debt facility with Silicon Valley Bank. Included in this facility is a four year term debt of $5 million and a revolving line of credit facility available for the remaining $5 million. The facility has a total debt capacity of $10 million. At December 31, 2008, there was an outstanding balance of $5 million under the term loan, and no outstanding balance under the revolving facility. The loan terms require us to meet certain covenants relating to minimum adjusted EBITDA, and other specified financial ratios. As of this filing, we are not aware that we are currently in default of any of these covenants, and we do not have reason to believe that we will be unable to comply with these covenants in the coming year based on our projected operations.

As part of the facility, Silicon Valley Bank issued a $479,667 letter of credit on our behalf to the Industrial Development Authority of Montgomery County, Virginia, as required under an office lease. The Silicon Valley Bank letter of credit was issued as a replacement for the previous letter of credit issued on our behalf by First National Bank in the amount of $599,583.

In December 2008, we entered into a First Amendment to Loan and Security Agreement with Silicon Valley Bank. The Amendment adjusted interest rates under the $10 million debt facility, revised certain minimum EBITDA covenants under the facility, and added intellectual property to the assets securing the facility. The new interest rate on the revolving line of credit is now a floating rate of the prime interest rate plus 1.0%, with a minimum rate of 5.0%. The new interest rate on the term loan is now a floating rate of the prime interest rate plus 1.5%, with a minimum rate of 5.5%.

Beginning in January 2009, we will pay interest and principal monthly, so that principal is paid back ratably over 42 months.

During the three months ended December 31, 2008, we began to experience the effects of a weakening overall economy, notably with respect to reduced sales of our test and measurement equipment. We implemented cost-cutting initiatives during this period in order to offset the effect of these reduced sales, including downsizing our workforce by approximately 20 positions; and reducing other expenses relating to employee benefit programs.

Discussion of Cash Flows

Recent Activity

During the year ended December 31, 2008, we used approximately $0.8 million of net cash from operations. This was a decrease of $3.5 million compared to 2007, when we used $4.2 million of net cash from operations. This change was due to the decreased net loss year over year, which contributed an additional $1.6 million to operating cash flow, and other working capital component changes. Specifically, the significant working capital component changes between December 31, 2008 and December 31, 2007 were: an increase in comparative operating cash flow due to increased accounts receivable collections of $4.9 million; and a decrease in comparative operating cash flow due to accounts payable and accrued expenses of $2.1 million.

Cash used in investing activities for the year ended December 31, 2008 related solely to the purchase of property and equipment and legal fees and costs associated with securing patent rights to certain technology. Our overall cash used in investing activities was $0.9 million in 2008 compared to $1.8 million in 2007. The decrease was attributable to decreased capital asset spending, which was higher in 2007 due to the early-stage capital needs of our business, including the purchase of office furniture and leasehold improvements relating to our Roanoke headquarters building. We saw fewer such needs in 2008 as a result of our prior investment.

Cash flows from financing activities for the year ended December 31, 2008 increased significantly compared to 2007. This was due primarily to proceeds received from our $5.0 million term loan as part of our Silicon Valley Bank debt facility.

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At December 31, 2008, total cash and cash equivalents were approximately $15.5 million.

Capital Expenditures

Capital expenditures for property and equipment, including purchased assets, assets acquired under capital leases, and capitalized software, totaled $0.4 million for 2008, a decrease of $1.0 million from capital expenditures of $1.4 million in 2007. The decrease from 2007 to 2008 was principally due to expenditures in 2007 for continuing build-out and furnishing of headquarters and other office space in Roanoke and Blacksburg locations, which we did not incur in 2008. We expect capital expenditures to increase somewhat in 2009, based on our expected requirements for growth in capacity and replacement and upgrades of equipment.

Summary of Contractual Obligations

We lease our facilities in Blacksburg, Charlottesville, Danville, Hampton, and Roanoke, Virginia under operating leases that expire between December 2009 and December 2014 or under a month-to-month arrangement. Upon expiration of the leases, we may exercise certain renewal options as specified in the leases.

We also lease certain computer equipment and software under capital lease agreements that expires between February 2009 and September 2013. The assets subject to these obligations are included in property and equipment on our consolidated balance sheet.

In September 2008, our Luna Technologies Division executed a non-cancelable, non-reschedulable $2.0 million purchase order for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in September 2008. As of December 31, 2008, approximately $1.4 remained under this commitment. The purchase order contains a provision permitting Luna Technologies to reduce the remaining commitment to $0.8 million, under certain circumstances that are beyond our control.

Set forth below is information concerning our known contractual obligations as of December 31, 2008 that are fixed and determinable.

	Total	2009	2010	2011	2012	2013	After 2013
Long-term debt obligations*	$ 10,901,644	$ 1,428,571	$ 1,428,571	$ 1,428,571	$ 6,615,931		
Capital equipment and software lease	4,672	4,672					
Operating facility leases	4,858,268	2,107,861	1,178,284	1,208,262	363,861		
Other operating leases	110,624	28,140	28,140	28,140	17,555	8,649	
Purchase order obligation	833,200	555,467	277,733				
Deferred Credits:							
City of Danville grant**	231,750	231,750					
Other liabilities***	5,119,500	355,500	395,500	467,500	367,500	402,500	3,131,000
Total	$ 22,059,658	$ 4,711,961	$ 3,308,228	$ 3,132,473	$ 7,364,847	$ 411,149	$ 3,131,000

* Long-term debt obligations consist of senior convertible promissory notes of aggregate principal amount of $5.0 million and accrued interest thereon held by Carilion Clinic, and a term facility with Silicon Valley Bank with an aggregate outstanding principal amount of $5.0 million.

** In March 2004, we received a $900,000 grant from the City of Danville, Virginia to be used for the expansion of economic and commercial growth within the City. Specifically, $450,000 of the grant will be

used to offset certain capital expenditures for leasehold improvements being made at our Danville facility, and the remaining $450,000 is to be used for our creation of new jobs.

In December 2008 we received a determination letter from the City of Danville that we had met 100% of the grant relating to job creation, and 29% relating to capital expenditures. As a result, we recognized $668,000 of the grant as other income for the year ended December 31, 2008. As of December 31, 2008, we had not fully met the capital expenditure milestone, and as a result, we may be required to repay the City of Danville $231,750 due to the shortfall of capital expenditures. Since we have not yet met the stipulations of the grant, we have recorded the $231,750 in deferred liabilities in the accompanying balance sheet as of December 31, 2008.

*** Other liabilities include remaining amounts payable for minimum royalty payments for certain licensed technologies.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined in Regulation S-K, Item 303(a)(4)(ii).

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. Our exposure to market risk is limited to interest rate fluctuations due to changes in the general level of United States interest rates, particularly because as of December 31, 2008, our cash reserves were maintained in money market investment accounts and were not exposed to material market risks.

Interest Rate Risk

We do not use derivative financial instruments as a hedge against interest rate fluctuations, and, as a result, interest income earned on our cash and cash equivalents and short-term investments is subject to changes in interest rates. However, we believe that the impact of these fluctuations does not have a material effect on our financial position due to the immediate available liquidity or short-term nature of these financial instruments. As of December 31, 2008, we had $15.5 million deposited in cash and cash equivalents bearing a weighted-average interest rate of 0.25%.

We are exposed to interest rate fluctuations, as a result of our Silicon Valley Bank term loan and revolving debt facility both having interest rates subject to market fluctuations. We do not currently use derivative instruments to alter the interest rate characteristics of any of our debt. The interest rate on our revolving debt facility with Silicon Valley Bank is at prime plus 1%. The interest rate on our $5.0 million term loan with Silicon Valley Bank is at prime plus 1.5%. The revolving debt facility and term loan have minimum interest rates of 5.0% and 5.5%, respectively. At December 31, 2008, the revolving debt facility and the term loan interest rates were the minimum rates provided by the Silicon Valley Bank loan agreement. Given the principal amount of our outstanding liabilities to Silicon Valley Bank, a change of the prime interest rate by one percentage point for one year would result in a change in our annual interest expense of approximately $50,000.

Foreign Currency Exchange Rate Risk

As of December 31, 2008, all payments made under our research contracts have been denominated in United States dollars. Our product sales to foreign customers are also denominated in U.S. dollars, and we do not receive payments in foreign currency. As such, we are not directly exposed to currency gains or losses resulting from fluctuations in foreign exchange rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Luna Innovations Incorporated

We have audited the accompanying consolidated balance sheets of Luna Innovations Incorporated (a Delaware corporation) and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2008. Our audits of the basic financial statements included the financial statement schedule listed in the index appearing under Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement 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. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 financial position of Luna Innovations Incorporated and subsidiaries as of December 31, 2008, and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

McLean, Virginia

March 13, 2009

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CONSOLIDATED BALANCE SHEETS

	December 31, 2007	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 12,046,945	$ 15,518,960
Accounts receivable, net	9,716,610	7,332,034
Refundable income taxes	396,062	98,092
Inventory, net	1,675,239	2,828,991
Other current assets	333,105	342,598
Total current assets	24,167,961	26,120,675
Property and equipment, net	5,859,515	5,363,957
Intangible assets, net	1,911,132	1,813,643
Deferred tax asset, net	600,000	600,000
Other assets	10,270	118,292
Total assets	**$ 32,548,878**	**34,016,567**
Liabilities and stockholders equity		
Current liabilities:		
Current portion of long term debt obligation		1,428,572
Current portion of capital lease obligation and accrued loss on sublease	23,885	17,396
Accounts payable	3,024,973	2,667,192
Accrued liabilities	5,331,798	5,161,308
Deferred credits	1,672,400	1,854,282
Total current liabilities	10,053,056	11,128,750
Long-term capital lease obligation net of current portion	4,671	
Long-term debt obligation	5,000,000	8,571,428
Deferred credits	354,418	
Total liabilities	15,412,145	19,700,178
Commitments and contingencies		
Stockholders equity:		
Common stock, par value $0.001, 100,000,000 shares authorized, 10,704,456 and 11,137,882 shares issued and outstanding at December 31, 2007 and 2008, respectively	10,704	11,138
Additional paid-in capital	34,496,063	37,960,928
Accumulated deficit	(17,370,034)	(23,655,677)
Total stockholders equity	17,136,733	14,316,389
Total liabilities and stockholders equity	**$ 32,548,878**	**34,016,567**

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

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CONSOLIDATED STATEMENTS OF OPERATIONS

	Year ended December 31,		
	2006	2007	2008
Revenues:			
Technology development revenues	$ 18,787,863	$ 23,356,456	$ 26,838,592
Product and license revenues	4,757,779	10,325,659	10,059,728
Total revenues	23,545,642	33,682,115	36,898,320
Cost of revenues:			
Technology development costs	14,140,605	16,546,140	17,626,495
Product and license costs	2,221,396	4,819,825	5,231,067
Total cost of revenues	16,362,001	21,365,965	22,857,562
Gross profit	7,183,641	12,316,150	14,040,758
Operating expense:			
Selling, general & administrative	13,935,381	16,082,582	17,688,065
Research, development, and engineering	3,214,814	4,487,897	3,646,590
Total operating expense	17,150,195	20,570,479	21,334,655
Operating loss	(9,966,554)	(8,254,329)	(7,293,897)
Other income:			
Other income	25,834	32,722	1,197,755
Interest income (expense), net	515,818	371,991	(189,501)
Total other income	541,652	404,713	1,008,254
Loss before income taxes	(9,424,902)	(7,849,616)	(6,285,643)
Income tax expense (benefit)	12,829		
Net loss	$ (9,437,731)	$ (7,849,616)	$ (6,285,643)
Net loss per share:			
Basic	$ (1.14)	$ (0.77)	$ (0.57)
Diluted	$ (1.14)	$ (0.77)	$ (0.57)
Weighted average shares:			
Basic	8,283,074	10,219,711	10,974,010
Diluted	8,283,074	10,219,711	10,974,010

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

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

	Class A Common Stock		Class B Common Stock		Class C Common Stock		Common Stock		Additional Paid in	Accumulated	
	Shares	$	Shares	$	Shares	$	Shares	$	Capital	Deficit	Total
Balance January 1, 2006	2,834,814	2,835	734,429	734	2,131,474	2,131			10,935,049	(86,872)	10,853,877
Exercise of stock options			139,049	139			132,606	133	96,931		97,203
Issuance of warrants and options in connection with Luna Technologies acquisition									418,073		418,073
Conversion of Class A, Class B, and Class C Common Stock to Common Stock	(2,834,814)	(2,835)	(873,478)	(873)	(2,131,474)	(2,131)	5,839,766	5,839			
Conversion of Redeemable Class B Common Stock to Common Stock							308,216	308	504,676		504,984
Initial Public Offering, net of costs							3,500,000	3,500	17,862,741		17,866,241
Carilion anti-dilution shares							96,724	97	(97)		
Rounding of fractional shares and par value effect of stock split							29	1	(4,184)	4,185	2
Share-based payments							34,205	34	1,772,573		1,772,607
Net loss										(9,437,731)	(9,437,731)
Balance December 31, 2006							9,911,546	9,912	31,585,762	(9,520,418)	22,075,256
Share-based payments							29,296	29	2,425,114		2,425,143
Exercise of options and warrants							763,614	763	485,187		485,950
Net loss										(7,849,616)	(7,849,616)
Balance December 31, 2007							10,704,456	10,704	34,496,063	(17,370,034)	17,136,733
Share-based payments							1,525	2	2,867,485		2,867,487
Shares issued in lieu of Senior Management bonus							62,922	63	309,153		309,216
Exercise of options and warrants							368,979	369	168,606		168,975
Warrants issued in connection with debt amendment									119,621		119,621
Net loss										(6,285,643)	(6,285,643)
Balance December 31, 2008							11,137,882	11,138	37,960,928	(23,655,677)	14,316,389

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2006	2007	2008
Cash flows used in operating activities:			
Net loss	$ (9,437,731)	$ (7,849,616)	$ (6,285,643)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	1,141,115	1,780,877	1,933,566
Share-based compensation	1,772,607	2,425,143	2,867,487
Change in operating assets and liabilities:			
Accounts receivable	(2,103,495)	(2,483,204)	2,384,576
Inventory		(831,945)	(1,566,809)
Refundable income taxes	118,735		297,970
Other assets	(654,563)	172,740	(59,322)
Accounts payable and accrued expenses	527,098	1,972,111	(157,628)
Deferred credits	(479,299)	597,724	(172,536)
Net cash used in operating activities	(9,115,533)	(4,216,170)	(758,339)
Cash flows used in investing activities:			
Acquisition of property and equipment	(2,834,385)	(1,375,612)	(391,210)
Intangible property costs	(558,909)	(414,328)	(536,251)
Net cash used in investing activities	(3,393,294)	(1,789,940)	(927,461)
Cash flows from financing activities:			
Proceeds from term loan			5,000,000
Payments on debt obligations		(214,953)	
Payments on capital lease obligation	(102,703)	(84,695)	(11,160)
Proceeds from the issuance of common stock, net	17,866,241		
Proceeds from the exercise of options and warrants	97,203	485,950	168,975
Net cash from financing activities	17,860,741	186,302	5,157,815
Net change in cash	5,351,914	(5,819,808)	3,472,015
Cash and cash equivalents beginning of period	12,514,839	17,866,753	12,046,945
Cash and cash equivalents end of period	$ 17,866,753	$ 12,046,945	$ 15,518,960
Supplemental disclosure of cash flow information			
Cash paid for interest	$ 45,341	$ 15,340	$ 193,125
Cash paid (received) for income taxes	$ 12,829		$ (297,970)
Supplemental schedule of non-cash activities			
Warrants issued in connection with debt modification			$ 58,194

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Luna Innovations Incorporated (Luna Innovations) was incorporated in the Commonwealth of Virginia in 1990 and subsequently reincorporated in the State of Delaware in April 2003. We are engaged in the research, development and commercialization of innovative technologies in the areas of test & measurement, sensing, and instrumentation products and health care products. We are organized into two main groups, which work closely together to turn ideas into products: our Technology Development Group and our Products Group. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative technologies to market. We identify technology that can fulfill identified market needs. We then take these solutions from the applied research stage through commercialization.

Basis of Presentation and Consolidation

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and include our accounts, our wholly owned subsidiaries and other entities in which we have a controlling financial interest. We consolidate all entities in which we own more than 50% of the outstanding voting stock unless we do not control the entity.

We eliminate all significant intercompany transactions from our financial results.

Use of Estimates

The preparation of our consolidated financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes. Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may differ from such estimates and assumptions.

Technology Development Revenues

We perform research and development for U.S. Federal government agencies, educational institutions and commercial organizations. We recognize revenues under research contracts when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred and collection of the contract price is considered probable. Revenues are earned under cost reimbursable, time and materials and fixed price contracts. Direct contract costs are expensed as incurred.

Under cost reimbursable contracts, we are reimbursed for allowable costs and paid a fixed fee. Revenues on cost reimbursable contracts are recognized as costs are incurred plus a portion of the fee earned. Revenues on time and materials contracts are recognized based on direct labor hours expended at contract billing rates plus other billable direct costs.

Revenue for fixed price research contracts that involve the delivery of services and a prototype model are recognized under the percentage of completion method in accordance with Statement of Position (SOP) 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*. Fixed price arrangements that involve the delivery of research reports are recognized under the proportional performance method based upon the ratio of costs incurred to achieve contract milestones to total estimated cost. Losses on contracts, if any, are recognized in the period in which they become known.

For the years ended December 31, 2006, 2007 and 2008, contract research revenues from agencies of the U.S. government accounted for approximately 87%, 68% and 73%, respectively, of total revenues for the same period. See Note 13 for additional details concerning our relationship with major customers.

Intellectual Property License Revenues

Amounts received from third parties for licenses to our intellectual property are recognized when earned under the terms of the agreements. Revenues are recognized upon transfer of the license unless we have continuing obligations for which fair value cannot be established, in which case the revenues are recognized over the period of the obligation. If there are extended payment terms, license fee revenues are recognized as these payments become due and collection is probable. We consider all arrangements with payment terms extending beyond 12 months not to be fixed and determinable.

Certain of our license arrangements have also required us to enter into research and development agreements. We apply the guidance from the Emerging Issues Task Force (EITF) Consensus on Issue 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21). Accordingly, we allocate our arrangement fees to the various elements based upon objective reliable evidence of fair value, if available. For those arrangements in which evidence of fair value is not available, we defer revenues from any up-front payments and recognize them over the service period in the arrangement. Certain of these arrangements also include the payment of performance bonuses based upon the achievement of specific milestones. Generally, there are no assurances at the onset of these arrangements that the milestones will be achieved. As such, fees related to such milestones are excluded from the initial allocation of the arrangement fee in accordance with EITF 00-21 and are recognized upon achievement of the milestone provided that all other revenue recognition criteria are met.

Product Sales Revenues

Revenues from product sales are generated by the sale of commercial products and services under various sales programs to the end user and through distribution channels. We sell fiber optic sensing systems to end users for use in numerous fiber-optic based measurement applications. Revenues are recorded net of applicable sales taxes collected from customers and payable to state or local governmental entities.

We recognize revenue relating to our products when pervasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured. Pursuant to the adoption of Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables,* we evaluate product sales that are a part of multiple-element revenue arrangements to determine whether separate units of accounting exist, and follow appropriate revenue recognition policies for each separate unit. Elements are considered separate units of accounting provided that (i) the delivered items has stand-alone value to the customer; (ii) there is objective and reliable evidence of the fair value of the undelivered item; (iii) if a general right of return exists relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially within our control. We allocate the overall contract consideration among the separate units of accounting based upon their fair values, with the amount allocated to the delivered item being limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions. We base the fair value of the undelivered items upon the normal pricing practice for those items, which is generally the price when sold separately.

For products containing software that is considered more than an incidental component, we consider the requirements of SOP 97-2, *Software Revenue Recognition.* We have concluded that our product sales do not include multiple deliverable elements, as we do not offer post contract customer support, technical services or upgrades and enhancements, or other related services, which would require deferring recognition of revenue relating to the product, absent the existence of fair value for any undelivered elements.

Revenues from product sales that require no ongoing obligations are recognized as revenues when shipped to the customer, title has passed and collection is reasonably assured. In transactions where a right-of-return exists, revenues are deferred until acceptance has occurred and the period for the right-of-return has lapsed. As of December 31, 2006, and 2007, we had not entered into sales transactions where rights of return exist. At December 31, 2008, we had entered into four such sales transactions, and had deferred revenue on our balance

sheet for the year ended December 31, 2008 of $0.2 million relating to them. We will recognize this revenue once the right-of-return has lapsed.

Allowance for Uncollectible Receivables

Accounts receivable are recorded at their face amount, less an allowance for doubtful accounts. We review the status of our uncollected receivables on a regular basis. In determining the need for an allowance for uncollectible receivables, we consider our customers financial stability, past payment history and other factors that bear on the ultimate collection of such amounts.

Cash Equivalents

We consider all highly liquid investments purchased with maturities of three months or less to be cash equivalents.

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, accounts receivables, accounts payable, a line-of-credit and accrued liabilities. The carrying amounts of financial instruments approximate fair value due to their short maturities. Additionally, the line-of-credit is subject to a variable interest rate based upon the prime rate as published by the Wall Street Journal.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. We record depreciation using the straight-line method over the following estimated useful lives:

Equipment	3 7 years
Furniture and fixtures	7 years
Software	3 years
Leasehold improvements	Lesser of lease term or life of improvements

Goodwill and Intangible Assets

Intangible assets consist of goodwill and patents related to certain intellectual property that we have developed or acquired. Goodwill represents the excess of the cost of an acquired entity over the net amounts assigned to tangible and intangible assets acquired and liabilities assumed. We apply the provisions of Statement of Financial Accounting Standards (SFAS) No. 142 *Goodwill and Other Intangible Assets*, which requires allocating goodwill to each reporting unit and testing for impairment using a two-step approach.

We perform a goodwill impairment test annually or whenever an event has occurred that would more likely than not reduce the fair value of a reporting unit below its carrying amounts. We engaged an outside service provider, who computed the estimated fair value of our reporting unit at December 31, 2008, using a discounted future cash flow method. The service provider computed future projected cash flows using information that we provided, including estimated future results of the reporting unit. We then compared the estimated fair value of the reporting unit to the carrying value of the reporting unit. Because the estimated fair value of the reporting unit exceeded the carrying value, we have not recognized an impairment related to goodwill for the years ended December 31, 2006, 2007, or 2008.

We account for patents in accordance with SFAS No. 144, *Accounting for Disposal or Impairment of Long-Lived Assets*. We amortize our patents over their estimated useful life of five years, and analyze them periodically to determine whether their carrying value has been impaired. At the end of December 31, 2008 and 2007, respectively, no patents were written down due to any impairment in value.

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Research and Development

Research and development costs not related to contract performance are expensed as incurred. We expensed $4.5 million and $3.5 million of non-contract related research and development expenses for the years ended December 31, 2007, and December 31, 2008, respectively.

Capitalized Software Costs

We did not capitalize any software development costs during the years ended December 31, 2007 or 2008. Costs related to the development of new software products and significant enhancements to existing software products are expensed as incurred until technological feasibility has been established and are amortized over three years.

Valuation of Long-Lived Assets

We account for long-lived assets in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by comparing the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of by sale are reflected at the lower of their carrying amount or fair value less cost to sell.

Inventory

Inventory consists of finished goods and parts valued at the lower of cost (determined on the first-in, first-out basis) or market. We provide reserves for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. Inventory reserves at December 31, 2007 and 2008 were $41,108 and $43,427, respectively.

Net Loss Per Share

We compute net loss per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic per share data is computed by dividing loss available to common stockholders by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing loss available to common stockholders by the weighted average shares outstanding during the period increased to include, if dilutive, the number of additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

The effect of 5,021,242 and 4,871,514 common stock equivalents (which include outstanding warrants and stock options) are not included for the year ended December 31, 2007 and 2008 respectively, as they are antidilutive to earnings per share. In addition, the conversion of the $5.0 million in convertible promissory notes would have been antidilutive.

Stock-Based Compensation

We have a stock-based compensation plan, which is described further in Note 8. Effective January 1, 2006, we adopted SFAS No. 123R, *Share Based Payment* (SFAS No. 123R) using the modified prospective transition method. New awards and awards modified, repurchased or cancelled after January 1, 2006 trigger compensation expense based on the fair value of the stock option as determined by the Black-Scholes option pricing model. We amortize stock-based compensation for such awards on a straight-line method over the related service period of

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the awards taking into account the effects of the employees expected exercise and post-vesting employment termination behavior.

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS 123R and EITF Issue No. 96-18.

The fair value of each option granted is estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions:

	2006	**2007**	**2008**
Risk-free interest rate range	4.55%	4.27% 4.77%	2.18% - 4.02%
Expected life of option-years	7	7.5	7.5
Expected stock price volatility	64%	56.8%	63% - 83%
Expected dividend yield			

The risk-free interest rate is based on US Treasury interest rates, the terms of which are consistent with the expected life of the stock options. For the years ended December 31, 2007 and 2006, expected volatility is based upon an average volatility of comparable public companies, since our common stock has only been trading since June 2006. For the year ended December 31, 2008, expected volatility is based upon the average volatility of our common stock. The expected life and estimated post employment termination behavior is based upon historical experience of homogeneous groups within our company.

During the year ended December 31, 2008 we granted 886,900 options to purchase shares of our common stock. We recognized $2.9 million in share-based payment expense, and we will recognize $6.2 million over the remaining requisite service period for all options granted through December 31, 2008.

Advertising

We expense the cost of advertising as incurred. Such amounts have not historically been significant to our operations.

Income Taxes

We account for income taxes using the liability method. Deferred tax assets or liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities as measured by the enacted tax rates which will be in effect when the differences reverse. A valuation allowance against net deferred assets is provided unless we conclude it is more likely than not that the deferred tax assets will be realized.

We also use the provisions of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48), in determining the recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We adopted FIN 48 beginning January 1, 2007, and the adoption did not have any impact on our consolidated financial statements.

Recent Accounting Pronouncements

In June 2008, the FASB ratified EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock* (EITF 07-5). EITF 07-5 addresses the determination of whether a financial instrument (or an embedded feature) is indexed to an entity s own stock. EITF 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of EITF 07-5 is not expected to have a material impact on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS 162 identifies a hierarchy for selecting accounting principles to be used in preparing financial statements

that are presented in conformity with U.S. GAAP for nongovernmental entities. SFAS 162 was effective on November 13, 2008.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) requires entities to recognize assets acquired, liabilities assumed, and any non-controlling interest in an acquiree, measured at the fair market value at the acquisition date. SFAS No. 141(R) is applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first fiscal year beginning after December 15, 2008. Since we have no current acquisition plans, we do not believe that the adoption of SFAS No. 141(R) will have a material impact on our financial statements. However, we expect SFAS No. 141(R) will have an impact if we have make an acquisition in future periods.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements*. SFAS No. 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary and the deconsolidation of a subsidiary. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and a non-controlling interest. SFAS No. 160 is effective for fiscal years ending on or after December 15, 2008. We expect SFAS No. 160 will only have an impact if we make acquisitions in future periods.

Recently Adopted Standards

In June 2007, the FASB ratified EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. The adoption of EITF 07-3 did not have a material impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. The adoption of SFAS No. 159 did not have a material impact on our consolidated financial statements.

Reclassifications

Certain reclassifications have been made to the 2006 and 2007 financial statements to conform to the 2008 presentation. Specifically, operating expenses have been broken out between selling, general & administrative and research & development and engineering on the Consolidated Statement of Operations.

2. Accounts Receivable Trade

Accounts receivable consist of the following at:

	December 31,	
	2007	**2008**
Billed	$ 6,898,762	$ 5,158,101
Unbilled	2,790,560	2,162,830
Other	56,822	33,476
	$ 9,746,144	$ 7,354,407
Less: allowance for doubtful accounts	(29,534)	(22,373)
	$ 9,716,610	$ 7,332,034

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Unbilled receivables result from contract retainages and revenues that have been earned in advance of billing and can be invoiced at contractually defined intervals or milestones, or at completion of the contract. Advance payments on uncompleted contracts were $0.4 million and $1.2 million for the periods ended December 31, 2007 and 2008, respectively, and are recorded as deferred revenue until earned. Contract retainage amounts were $0.2 million and $0.5 million for the periods ended December 31, 2007 and 2008, respectively, and are recorded as unbilled accounts receivable until final settlement of the underlying contracts.

3. Property and Equipment

Property and equipment, net, consists of the following at:

	December 31,	
	2007	2008
Equipment	$ 5,525,092	$ 6,188,850
Furniture and fixtures	607,682	621,776
Software	1,106,893	1,170,767
Leasehold improvements	3,193,048	3,255,589
	10,432,715	11,236,982
Less accumulated depreciation	(4,573,200)	(5,873,025)
	$ 5,859,515	$ 5,363,957

Depreciation for the periods ended December 31, 2006, 2007, and 2008 was approximately $0.8 million, $1.3 million, and $1.3 million, respectively.

4. Intangible Assets

The following is a summary of intangible assets:

	December 31,	
	2007	2008
Goodwill	$ 418,073	$ 418,075
Patent costs	1,815,756	2,002,975
Other capitalized intellectual property rights	537,299	742,667
Accumulated amortization	(859,996)	(1,350,074)
	$ 1,911,132	$ 1,813,643

Amortization for the periods ended December 31, 2006, 2007, and 2008 was approximately $346,000, $535,000, and $634,000, respectively**.** No impairment loss was recognized for the period ending December 31, 2006, 2007 or 2008.

Estimated aggregate amortization for each of the next five years is as follows:

Year Ended December 31,	
2009	$ 600,128
2010	417,075

2011	275,071
2012	85,219
2013	17,644
Thereafter	431
	$ 1,395,568

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5. Accrued Liabilities

Accrued liabilities consist of the following at:

	December 31,	
	2007	2008
Accrued compensation and related liabilities	$ 1,386,239	$ 1,431,779
Accrued professional fees	526,204	1,214,779
Accrued severance and bonuses	1,341,436	153,617
Accrued royalty	221,810	283,179
Deferred rent	884,660	717,978
Accrued interest	600,822	943,866
Other	370,627	416,110
	$ 5,331,798	$ 5,161,308

6. Debt Agreements

Working Capital Facility

Until May 2008, we had a $3.0 million senior secured revolving credit facility with First National Bank that was collateralized by a security interest in substantially all of our assets. The interest rate on borrowings under our secured revolving credit facility was equal to the prime rate, limited to no less than 6.0% and no greater than 10.0% per annum, with interest payable monthly. This agreement also provided a $1.0 million sub-limit for letters of credit.

In May 2008, we entered into a $10.0 million credit facility with Silicon Valley Bank, which includes a four year term debt of $5.0 million and a four-year revolving line of credit facility available for the remaining $5.0 million, based on the balance of our term loan at December 31, 2008. The interest rate on borrowings under the secured revolving facility was a floating per annum rate of 0.5% above the prime interest rate. Interest on the term loan was a floating per annum rate of 1.0% above the prime interest rate. This agreement also provided a $1.0 million sub-limit for letters of credit. As part of this agreement, we provided blanket collateral of substantially all of the company s assets, and agreed to be subject to certain loan covenants, including but not limited to, financial covenants requiring the on-going attainment of certain financial ratios, and the attainment of a minimum adjusted EBITDA that increases through-out the first year of the term loan period. In connection with the credit facility with Silicon Valley Bank, Carilion Clinic agreed to extend the maturity date of the existing $5.0 million aggregate principal amount in notes payable to Carilion Clinic to December 31, 2012, from the original date of December 30, 2009, and to subordinate the Carilion Clinic debt to that of Silicon Valley Bank.

In December 2008, we entered into a First Amendment to Loan and Security Agreement with Silicon Valley Bank. The Amendment adjusts interest rates under the $10 million debt facility, revises certain minimum EBITDA covenants under the facility, and includes intellectual property to the assets securing the facility. The new interest rate on the revolving line of credit is a floating rate of the prime interest rate plus 1.0%, with a minimum rate of 5.0%. The new interest rate on the term loan is a floating rate of the prime interest rate plus 1.5%, with a minimum rate of 5.5%.

Beginning in January 2009, we will pay interest and principal monthly on the term note over 42 months.

Convertible Debt

As more fully described in Note 12, we have outstanding promissory notes of $5,000,000 in the aggregate which are convertible, at the option of the holder, into shares of our Common Stock. The notes accrue simple interest at a rate of 6% annually and mature on December 31, 2012. As previously discussed, in May 2008, we amended the terms of our notes with Carilion Clinic to extend their due date to December 31, 2012 and to

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subordinate them to our new credit facility with Silicon Valley Bank. We issued warrants to purchase 10,000 shares of Luna Common Stock at a price of $7.98 per share in connection with the amended terms. The warrants expire on December 31, 2017. We valued the warrants using the Black-Scholes option pricing model, and recorded a deferred financing charge of $58,194.

The following table presents a summary of debt.

	December 31	
	2007	2008
Carilion Clinic financing (see note 12)	$ 5,000,000	$ 5,000,000
Silicon Valley Bank Term Loan		5,000,000
	$ 5,000,000	$ 10,000,000
Less: currently payable		1,428,572
Total long-term debt	$ 5,000,000	$ 8,571,428

Future maturities of long-term debt as of December 31, 2008 are as follows:

	Amount
Year ending December 31,	
2009	$ 1,428,571
2010	1,428,571
2011	1,428,571
2012	5,714,287
Total debt	$ 10,000,000

Costs associated with loans outstanding were as follows:

	December 31, 2006	December 31, 2007	December 31, 2008
Interest expense	$ 335,722	$ 318,480	$ 500,311
Amortization of transaction costs			$ 10,478
Total interest expense	$ 335,722	$ 318,480	$ 489,833

7. Income Taxes

Deferred tax assets and liabilities consist of the following components:

	December 31,	
	2007	2008
Research and development credits	$ 293,253	$ 386,161
Net operating loss carryforwards	7,030,624	7,745,382
Accrued liabilities	799,299	491,277
Stock-based compensation	438,191	615,902

Depreciation and amortization	(162,776)	438,121
Bad debt and inventory reserve	26,816	20,828
	8,425,407	9,697,671
Valuation allowance	(7,825,407)	(9,097,671)
Net deferred tax asset	$ 600,000	$ 600,000

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The reconciliation of expected income tax expense (benefit) to actual income tax expense (benefit) was as follows:

	2006	2007	2008
Statutory federal rate	34.0%	34.0%	34.0%
State tax net of federal benefit	3.96%	3.96%	3.96%
Research and development credit and carryforwards	12.04%	1.69%	1.48%
Change in valuation allowance	(55.94%)	(7.78%)	(20.24%)
Permanent differences and other	6.08	(31.87%)	(19.20%)
Income tax expense (benefit)	0.14%	0.00%	0.00

The income tax provision (benefit) consists of the following for:

	2006	2007	2008
Current:			
Federal	$	$	$
State	12,829		
Deferred Federal			
Deferred State			
Income tax expense (benefit)	$ 12,829	$	$

The realization of our deferred income tax assets is dependent upon sufficient future taxable income in future periods that deductible temporary differences are expected to be available to reduce taxable income. In assessing whether deferred tax assets may be realized, we consider whether it is more likely than not that some portion, or all, of the deferred tax asset will be realized. We consider scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies that we can implement in making our assessment. We have net operating loss carry forward at December 31, 2008 of approximately $20 million expiring at varying dates through 2026. We have recorded a refundable income tax receivable of approximately $98,000, representing net operating losses that we have carried back to recover state income taxes previously paid. We have research & development tax credit carryforwards of approximately $0.4 million, which expire at varying dates through 2026.

A tax benefit of $600,000 was recorded at December 31, 2007 and 2008, based upon management s assessment that it was at those dates more likely than not that a portion of the entire deferred tax benefit would be realized in future periods. Our assessment is based on a projection of the amount of federal taxable income that we estimate will be generated in future years, as well as an analysis of certain other evidentiary indicators, notably, that operating expenses have declined as a proportion of revenue for each year that we have been public, and our annual net loss has regularly declined.

We are regularly examined by federal and various state tax authorities. The U.S. federal statute of limitations remains open for the year 2002 and onward. We currently have no federal income tax returns under examination. U.S. state jurisdictions have statutes of limitation generally ranging from three to seven years. We currently have no state income or franchise tax returns under examination. We currently do not file tax returns in any foreign tax jurisdiction.

We currently have no positions for which we expect that the amount of unrecognized tax benefit will increase or decrease significantly within twelve months of the reporting date. We have no tax interest or penalties reported in either our statement of operations or statement of financial position for any year reported herein.

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8. Stockholders Equity

Common Stock

Upon the completion of our initial public offering, all of the outstanding shares of Class A Common Stock, Class B Common Stock and Class C Common Stock were converted into one class of common stock on a one-for-one basis. As such, all options and warrants to purchase Class A, B, or C shares are satisfied with Common Stock.

Warrants

In February 2006, we issued warrants for the purchase of 57,542 shares of our Class B Common Stock at an exercise price of $1.77 per share to former Luna Technologies shareholders to prevent dilution by a concurrent stock option grant. Class B Common Stock was converted into Common Stock upon the completion of our public offering, on a one-to-one basis. The warrants were valued using a Black-Scholes option pricing model with the following assumptions: risk-free rate of 4.55%, expected volatility of 64%, and an expected life of 10 years, which equaled the contractual term. The aggregate fair value of the warrant was $418,074, and was recorded as additional purchase price for the Luna Technologies acquisition.

In May 2008, we issued 10,000 warrants for the purchase of Luna Common Stock at an exercise price of $7.98 per share to Carilion Clinic, in exchange for Carilion agreeing to subordinate their convertible debt to the Silicon Valley Bank debt facility, and to extend the payment of their convertible debt from December 31, 2009 to December 31, 2012. The warrants were valued using the Black-Scholes option pricing model with the following assumptions: risk free rate of 3.81%, expected volatility of 63%, and an expected life of 9.63 years, which equaled the contractual term. The aggregate fair value of the warrant was $58,194, and this amount was recorded as a deferred prepaid financing charge.

Incentive Stock Option Plan

In April 2003, we adopted the Luna Innovations Incorporated 2003 Stock Plan (the 2003 Plan). Under the 2003 Plan, our Board of Directors was authorized to grant both incentive and non-statutory stock options to employees, directors and consultants of our Company to purchase Class B shares of Common Stock. Options generally had a life of 10 years and exercise price equal to or greater than the fair market value of the Class B Common Stock as determined by the Board of Directors. On February 4, 2006, our Board of Directors increased the number of shares reserved under the 2003 Plan to 9,715,000. We have 3,024,186 options that are outstanding under the 2003 Plan for the year ended December 31, 2008. Pursuant to the adoption of the 2006 Equity Incentive Plan in January 2006, no shares or options are available for future grant under the 2003 Plan, except to satisfy grants outstanding as of June 5, 2006.

In August 2003, our Board of Directors authorized an option exchange program expiring on September 19, 2003 whereby option holders of Class A Common Stock issued under the 1999 plan were given the opportunity to exchange their options for options to purchase Class B Common Stock on a one for one basis. The new option grants were immediately vested on the date of exchange, September 29, 2003, had an exercise price of $0.35 and a life of 10 years from the date of grant. Upon completion of the option exchange program, the 1999 plan was terminated.

All of the outstanding options from the 1999 Plan had exercise prices in excess of the fair value of our Class A Common Stock as of the date of the exchange. As such, the option exchange was accounted for as a re-pricing in accordance with FIN 44. A total of 172,525 options were exchanged in connection with this transaction, of which 22,335 were outstanding at December 31, 2006, 2007, and 2008, respectively.

In January 2006, we adopted our 2006 Equity Incentive Plan (the 2006 Plan). Under the 2006 Plan, our Board of Directors was authorized to grant both incentive and non-statutory stock awards to employees,

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directors, and consultants of our Company to purchase common stock. Awards generally have a life of 10 years and exercise price equal to the closing price of our common stock on the date of the option grant. Each year, the number of shares available for issuance increases by the lesser of (a) 10% of the outstanding shares of our common stock on the first day of the fiscal year; (b) 1,695,690 shares; or (c) such other amount as our board of directors may determine. A total of 6,214,552 and 6,777,640 shares were available for future grant under the 2006 Plan as of December 31, 2007 and 2008, respectively.

Vesting typically occurs over a five year period.

Total non-cash stock option expense for the years ended December 31, 2006, 2007 and 2008 was $1.7 million, $2.4 million, and $2.9 million, respectively.

The following table sets forth the activity of our stock options to purchase common stock:

	Options Outstanding				Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
Balance at January 1, 2006	3,975,555	0.35 1.77	0.65	$ 3,962,864	1,519,445	$ 0.36	$ 1,961,849
Forfeited	(178,444)	0.35	0.35				
Exercised	(271,648)	0.35	0.35				
Granted	1,457,131	1.77	1.77				
Balance at December 31, 2006	4,982,594	0.35 7.08	1.26	$ 12,215,503	2,322,665	$ 2.99	$ 6,935,997
Forfeited	(478,320)	0.35 6.00	2.04				
Exercised	(743,359)	0.35 1.77	0.68				
Granted	986,900	3.16 8.20	4.55				
Balance at December 31, 2007	4,747,815	0.35 8.20	1.95	$ 31,477,522	2,543,218	$ 0.96	$ 19,366,620
Forfeited	(468,839)	0.35 8.20	5.45				
Exercised	(365,430)	0.35 6.00	0.46				
Granted	886,900	2.11 8.04	6.14				
Balance at December 31, 2008	4,800,446	0.35 8.20	2.53	$ 2,853,667	2,967,610	$ 1.28	$ 2,665,403

(1) The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise price of the option of in-money options only. The prices represent the closing price of our Common Stock on the NASDAQ Global Market on the respective dates.

	Options Outstanding				Options Exercisable	
	Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Life in Years	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price of Options Exercisable
Year ended December 31, 2006	$ 0.35 $7.08	4,982,594	8.2	1.26	2,322,665	0.60
Year ended December 31, 2007	$ 0.35 $8.20	4,747,815	7.8	1.95	2,543,218	0.96
Year ended December 31, 2008	$ 0.35 $8.20	4,800,446	7.2	2.53	2,967,610	1.28

The following table sets forth information regarding the weighted average grant-date fair value, for non-stock option equity instruments we issued during 2008:

	Number of Shares	Weighted-average grant date fair value
Non-vested at January 1, 2008		$
Non-vested at December 31, 2008	10,000	58,194
Granted during 2008	74,447	387,664
Vested during 2008	64,447	329,470
Forfeited during 2008		

The following table sets forth information regarding the total intrinsic value of options exercised, and the total fair value of shares vesting:

	Total intrinsic value of options exercised	Total fair value of options vested
Year ended December 31, 2006	1,030,805	-0-
Year ended December 31, 2007	3,550,911	-0-
Year ended December 31, 2008	1,910,675	1,573,725

For the year ending December 31, 2008, 2007, and 2006, the weighted average grant date fair value of options granted was $4.13, $3.01, and 4.65, respectively. We estimate the fair value of options at the grant date using the Black-Scholes model.

We recognized $2.9 million in share-based payment expense, and we will recognize $6.2 million over the remaining requisite weighted average service period of 7.2 years for all options granted through December 31, 2008.

9. Commitments and Contingencies

Obligation Under Operating Leases

We lease our facilities in Blacksburg, Charlottesville, Danville, Hampton, and Roanoke, Virginia under non-cancelable operating leases that expire between May 2009 and December 2014. Certain of the leases are subject to fixed escalations. We recognize rent expense on such leases on a straight-line basis over the lease term. Rent expense under these leases was approximately $0.9 million, $1.4 million, and $1.3 million for the years ended December 31, 2006, 2007 and 2008, respectively.

Minimum future rentals, as of December 31, 2008, under the aforementioned operating leases for each of the next five periods ending are:

2009	$ 2,136,001
2010	1,206,424
2011	1,236,402
2012	381,416
2013	8,649
Thereafter	
	$ 4,968,892

We subleased our McLean facility during 2008. We will receive future payments of $189,065 during the remaining life of the sublease.

New Facility Lease

We amended the lease for our Charlottesville facility, which now expires in December 2014. This lease is cancellable at the end of 2009 with a penalty equal to 50% of the lease payments remaining for the remainder of the lease term at that time. Since we include only minimum payments in the table above, we do not include any amounts in 2013 or 2014 for the Charlottesville facility lease.

Obligation Under Capital Leases and Accrued Loss on Sublease

We are obligated under capital leases covering certain equipment that expire at various dates during 2009.

The gross amount of property and equipment and related accumulated amortization recorded under capital leases were as follows at December 31:

	2007	2008
Equipment	$ 398,529	$ 398,529
Software	42,252	42,252
	440,781	440,781
Less accumulated amortization	(388,088)	(436,199)
	$ 52,693	$ 4,582

Governor s Opportunity Fund

In March 2004, we received a $900,000 grant (the Grant) from the City of Danville, Virginia (the City) to be used for the expansion of economic and commercial growth within the City. Specifically, $450,000 of the grant will be used to offset certain capital expenditures for leasehold improvements being made at our Danville facility. The remaining $450,000 is granted for the creation of new jobs upon satisfaction of the conditions described below.

The Grant stipulated that we must make estimated capital expenditures of at least $6,409,000 and create 54 new full time jobs at our Danville facility, at an average wage of at least $39,000 plus benefits within 30 months of the award, and then maintain such employment levels for an additional 30 months.

In December 2008 we received a determination letter from the City of Danville indicating that we had met 100% of the conditions of the Grant relating to job creation and 29% of the conditions of the grant relating to capital expenditures. As a result, we recognized $668,000 of the Grant proceeds as other income for the year ended December 31, 2008 and correspondingly reduced the deferred liability of $900,000 on our balance sheet.

As of December 31, 2008, we had not fully met the capital expenditure milestone, and, as a result, we may be asked to repay the City of Danville $232,000 due to the pro rata shortfall of capital expenditures falling below required levels. Because of the failure to meet these milestones and the continuing obligation to maintain our investment and employees at this location through March 9, 2009, we have classified $232,000 of the grant as a current deferred credit on our balance sheet in anticipation of potentially returning the funds in March 2009.

Purchase Commitment

In September 2008, our Luna Technologies Division executed a non-cancelable, non-reschedulable $2.0 million purchase order for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in September 2008. As of December 31, 2008, approximately $1.4 million of this commitment remained. At the option of the Luna Technologies Division, this commitment may be reduced to $0.8 million in May 2009, under certain circumstances that are beyond our control.

Royalty Agreement

We have licensed certain third-party technology from a vendor that provides for minimum royalties aggregating $3.2 million payable over the remaining patent terms of the underlying technology.

10. Employee Profit Sharing Plan

We maintain a salary reduction/profit-sharing plan under provisions of Section 401(k) of the Internal Revenue Code. The plan is offered to employees who have completed three months of service with us. In 2008, we contributed 50% of the salary deferral elected by each employee up to a maximum deferral of 10% of annual salary. In 2009, we will contribute 25% of the salary deferral elected by each employee up to a maximum deferral of 10% of annual salary.

We may, at our option, contribute additional amounts to the plan. We contributed approximately $0.4 million, $0.5 million, and $0.5 million to the plan for the years ended December 31, 2006, 2007 and 2008, respectively.

11. Litigation and Other Contingencies

From time to time, we may become involved in litigation in relation to claims arising out of our operations in the normal course of business. While management currently believes the amount of ultimate liability, if any, with respect to these actions will not materially affect our financial position, results of operations, or liquidity, the ultimate outcome of any litigation is uncertain. Were an unfavorable outcome to occur, or if protracted litigation were to ensue, the impact could be material to us.

On May 30, 2006, we were served with a complaint filed by a former employee in the Circuit Court for the City of Roanoke, Virginia, alleging that we breached a consulting agreement with the former employee, and that we are indebted to the former employee in an unspecified amount of at least $100,000. We have answered the complaint and intend to defend ourselves vigorously in this matter. While we believe the former employee s claims are without merit, counsel for such former employee has indicated that he may file additional claims against us. To date, no such additional claims have been filed. However, we cannot predict whether such former employee will file additional litigation against us or our subsidiaries or the ultimate outcome of any such litigation.

On June 22, 2007, Hansen Medical Inc., or Hansen, a company for which we had conducted certain research and performed certain services, filed a complaint against us in the Superior Court of the State of California, County of Santa Clara. On March 18, 2008, the complaint was amended and alleges misappropriation of trade secrets, aiding and abetting breach of fiduciary duty, unfair competition, breach of contract, conversion, intentional interference with contract, breach of implied covenant of good faith and fair dealing, declaratory judgment, and fraud. In addition to monetary damages in an unspecified amount, the plaintiff company seeks, among other things, equitable relief, including an injunction against our using the allegedly misappropriated Hansen trade secrets in connection with our work with Intuitive Surgical, Inc., or otherwise. We have answered the complaint and intend to defend ourselves vigorously in this matter. Hansen s claim of conversion has since been dismissed. We also filed a counterclaim against Hansen and an amended counterclaim on March 18, 2008. Our counterclaim asserts claims for declaratory judgment, misappropriation of trade secrets, breach of contract, unfair competition under the California Business and Professional Code, breach of implied covenant of good faith and fair dealing and unjust enrichment. We seek money damages from Hansen in an amount to be proven at trial and equitable, including declaratory, relief. In April 2008, the parties participated in a non-binding arbitration. In May 2008, the arbitrator rendered a non-binding award. In June 2008, we rejected the non-binding award, and the case is proceeding to trial on the merits, currently scheduled to begin in March 2009. While we cannot currently determine the ultimate liability pursuant to these actions, if we are unsuccessful in our litigation with Hansen, our business may be materially harmed. Not only may we not recover any damages, if Hansen is successful, we may be required to pay substantial damages, and we could lose the ability to freely use or license others to use certain intellectual property, any or all of which could materially harm our business.

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On September 10, 2007, we filed a complaint against our former auditing and accounting firm in connection with the firm s auditing and opining on the accuracy of several years of our consolidated financial statements in preparation for our registration with the Securities and Exchange Commission and our initial public offering of securities. On July 23, 2008, the parties settled the litigation at mediation without any admission of liability, or adjudication of fact or law. The material terms of settlement include payment to Luna and a mutual general release, as well as joint dismissal with prejudice of all claims and counterclaims. We recorded $0.5 million in other income related to this settlement which is composed of the proceeds, less related legal expenses.

We have made, and will continue to make, efforts to comply with current and future environmental laws. We anticipate that we could incur additional capital and operating costs in the future to comply with existing environmental laws and new requirements arising from new or amended statutes and regulations. In addition, because the applicable regulatory agencies have not yet promulgated final standards for some existing environmental programs, we cannot at this time reasonably estimate the cost for compliance with these additional requirements. The amount of any such compliance costs could be material. We cannot predict the impact that future regulations will impose upon our business.

12. Carilion Promissory Notes

In 2005, we sold promissory notes to Carilion Clinic (Carilion) that are convertible into Common Stock at a fixed rate of $4.69159 per share. These notes accrue simple interest at a rate of 6.0% per year were originally payable on December 30, 2009 or a later date if extended by the holders of a majority of the aggregate principal amount of the notes, absent acceleration due to an event of default. The holders of a majority of the aggregate principal amount of the notes may also extend the maturity date of these notes for one additional year by providing notice to us and may further extend the maturity date for up to an additional three consecutive one year periods if we are not eligible for or have elected not to pursue SBIR funding. After the first extension, if any, we will have the right to repay any accrued interest in cash rather than common stock. The holders of these notes have the option to convert their notes (subject to certain limitations) into shares of our common stock at maturity or upon the occurrence of certain events prior to this offering. In addition, the holders may convert their notes (subject to certain limitations) into shares of common stock if we are no longer eligible for SBIR grants or have not applied for an SBIR grant within the preceding 12 months.

Our amended and restated investor rights agreement grants Carilion and certain other shareholders the rights to require us to register their shares of Common Stock for resale. Although we could be required to register shares held by these shareholders, there is no liquidated damages provision in the event such shares are not registered and the conversion of such debt can be satisfied with unregistered shares of Common Stock.

As previously discussed, in May 2008, we amended the promissory notes sold to Carilion, by extending the payable date from December 30, 2009 to December 31, 2012, and by subordinating these notes to our Silicon Valley Bank debt facility.

13. Relationship with Major Customers

During the years ended December 31, 2006, 2007 and 2008, approximately 87%, 68% and 73%, respectively, of our consolidated revenues were attributable to contracts with the U.S. government.

During the years ended December 31, 2007 and 2008, receivables with respect to contracts with the U.S government represented 81% and 75% of total trade receivables, respectively.

14. Financial Information About Segments

Our operations are divided into two operating segments- Technology Development and Product and Licensing. The Technology Development segment provides applied research to customers in our areas of focus.

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Our engineers and scientists collaborate with our network of government, academic and industry experts to identify technologies and ideas with promising market potential. We then compete to win fee-for-service contracts from government agencies and industrial customers who seek innovative solutions to practical problems that require new technology. The Technology Development segment derives its revenue primarily from services.

The Product and Licensing segment develops and sells products or licenses technologies based on commercially viable concepts developed by the Technology Development segment. The Product and Licensing segment derives its revenue from product sales, funded product development and technology licenses.

The Chief Executive Officer and his direct reports collectively represent our chief operating decision makers, and they evaluate segment performance based primarily on revenue and operating income or loss.

There are no significant inter-segment sales. There was an insignificant amount of product sales made outside the U.S.

	Twelve Months Ended Dec 31,		
	2006	**2007**	**2008**
Technology Development Revenue	$ 18,787,863	$ 23,356,456	$ 26,838,592
Product and License Revenue	4,757,779	10,325,659	10,059,728
Total Revenue	$ 23,545,642	$ 33,682,115	$ 36,898,320
Technology Development Operating Loss	$ (4,243,331)	$ (3,898,626)	$ (1,322,542)
Product and License Operating Loss	(5,723,223)	(4,355,703)	(5,971,355)
Total Operating Loss	$ (9,966,554)	$ (8,254,329)	$ (7,293,897)

Additional segment information is as follows:

	December 31, 2007	**December 31, 2008**
Total segment assets:		
Technology Development	$ 27,303,342	$ 26,559,928
Product and License	5,245,536	7,456,639
Total	$ 32,548,878	$ 34,016,567

15. Quarterly Results

The following table sets forth our unaudited historical revenues, operating income and net loss by quarter during 2007 and 2008:

	Quarter Ended							
(Dollars in thousands, except per share amounts)	**Mar. 31, 2007**	**Jun. 30, 2007**	**Sep. 30, 2007**	**Dec. 31, 2007**	**Mar. 31, 2008**	**Jun. 30, 2008**	**Sep. 30, 2008**	**Dec. 31, 2008**
Revenues:								
Technology development	$ 5,287	$ 5,852	$ 5,952	$ 6,265	$ 6,602	$ 6,947	$ 7,247	$ 6,043
Product and license	1,784	2,003	2,867	3,671	2,318	2,931	3,457	1,354

Total revenues	7,071	7,855	8,820	9,936	8,920	9,878	10,704	7,397
Operating loss	(2,795)	(2,291)	(1,982)	(1,186)	(1,876)	(1,765)	(1,105)	(2,544)
Net loss	$ (2,682)	$ (2,178)	$ (1,838)	$ (1,151)	$ (1,852)	$ (1,798)	$ (473)	$ (2,161)
Net loss per share:								
Basic	$ (0.27)	$ (0.21)	$ (0.18))	$ (0.11)	$ (0.17)	$ (0.16)	$ (0.04)	$ (0.19)
Diluted	$ (0.27)	$ (0.21)	$ (0.18)	$ (0.11)	$ (0.17)	$ (0.16)	$ (0.04)	$ (0.19)
Weighted average shares:								
Basic	9,969,373	10,136,446	10,293,557	10,465,501	10,781,363	10,935,370	11,055,613	11,118,249
Diluted	9,969,373	10,136,446	10,293,557	10,465,501	10,781,363	10,935,370	11,055,613	11,118,249

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. (T) CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 (the Exchange Act) Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the Evaluation Date), have concluded that as of the Evaluation Date, our disclosure controls and procedures are effective, in all material respects, to ensure that information required to be disclosed in the reports that we file and submit under the Exchange Act (i) is recorded, processed, summarized and reported as and when required and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) under the Exchange Act. Our internal control over financial reporting is designed, under the supervision of our chief executive and chief financial officers, and effected by our board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America (GAAP). Our internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

We conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008. This evaluation was based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Based on our evaluation under the framework in *Internal Control Integrated Framework*, our Chief Executive Officer and Chief Financial Officer concluded that internal control over financial reporting was effective as of December 31, 2008.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management s report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management s report in this annual report.

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ITEM 9B. OTHER INFORMATION.

2009 Senior Management Incentive Compensation Plan

On March 11, 2009, the Compensation Committee of our Board of Directors approved our written Senior Management Incentive Compensation Plan for fiscal 2009 (the 2009 Plan). Under the terms of the 2009 Plan, our principal executive officer, our principal financial officer and other named executive officers are eligible for annual bonus payments based upon a percentage of their respective 2009 annual salaries and the achievement of specified objectives. Depending upon actual performance versus objectives, eligible participants could receive between zero and 150% of their individual target bonus percentage. Eligibility is triggered only if we demonstrate positive Adjusted EBITDA (as such term is defined in the 2009 Plan) during the third and fourth quarters of 2009. After this trigger is achieved, a bonus is awarded for each financial component if the respective minimum level for each component is achieved. The awards are calculated based upon the participant s overall target with component weights as follows: 30% based on the achievement of the budgeted 2009 net loss target, 30% based on the achievement of the budgeted Adjusted EBITDA target for the third and fourth quarters of 2009, 30% based upon a targeted rate of cash usage and 10% on the participant s individual 2009 performance goals being met. Bonuses may be paid, if earned, in cash, stock, or a combination of cash and stock.

A copy of the 2009 Plan is filed with this Annual Report on Form 10-K as exhibit 10.38 and is incorporated herein by reference.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 of Form 10-K is incorporated by reference to our Proxy Statement for the 2009 Annual Meeting of Stockholders anticipated to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2008. Certain information required by this item concerning our executive officers is set forth in Part I, Item 1 of this Annual Report on Form 10-K, under Executive Officers of the Registrant.

ITEM 11. EXECUTIVE COMPENSATION.

The information required by Item 11 of Form 10-K is incorporated by reference to our Proxy Statement for the 2009 Annual Meeting of Stockholders anticipated to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2008.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K is incorporated by reference to our Proxy Statement for the 2009 Annual Meeting of Stockholders anticipated to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2008.

EQUITY COMPENSATION PLANS

The following table summarizes our equity compensation plans as of December 31, 2008:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	4,800,446	$ 2.53	6,777,640
Equity compensation plans not approved by security holders			
Total	4,800,446	$ 2.53	6,777,640

Our 2006 Equity Incentive Plan provides for annual increases in the number of shares available for issuance thereunder on the first day of each fiscal year, beginning with our 2007 fiscal year, equal to the least of: (i) 10% of the outstanding shares of our common stock on the last day of the immediately preceding fiscal year; (ii) 1,695,690 shares; or (iii) such other amount as our board of directors may determine.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 of Form 10-K is incorporated by reference to our Proxy Statement for the 2009 Annual Meeting of Stockholders anticipated to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2008.

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ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated by reference to our Proxy Statement for the 2009 Annual Meeting of Stockholders anticipated to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2008.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULE

(a) The following documents are filed as part of this Annual Report on Form 10-K:

(1) Financial Statements. See Index to Consolidated Financial Statements at Item 8 of this Report on Form 10-K.

(2) Schedules.

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Schedule II

Luna Innovations Incorporated

Valuation and Qualifying Accounts

Column A	Column B Balance at beginning of Period	Column C Charged to costs and expenses	Column D Deductions	Column E Valuation allowance against deferred tax asset	Column F Balance at end of period
Year Ended December 31, 2008					
Reserves deducted from assets to which they apply:					
Allowances for doubtful accounts	$ 29,534	$	$ (7,161)	$	$ 22,373
Inventory	41,108	2,319			43,427
Valuation allowance against deferred tax asset	7,825,407			1,272,264	9,097,671
	7,896,049	2,319	(7,161)	1,272,264	9,163,471
Year Ended December 31, 2007					
Reserves deducted from assets to which they apply:					
Allowances for doubtful accounts	$ 19,010	$ 12,472	$ (1,948)	$	$ 29,534
Inventory	40,943	165			41,108
Valuation allowance against deferred tax asset	7,214,667			610,740	7,825,407
	7,274,620	12,637	(1,948)	610,740	7,896,049
Year Ended December 31, 2006					
Reserves deducted from assets to which they apply:					
Allowances for doubtful accounts	$	$ 44,005	$ (24,995)	$	$ 19,010
Inventory	56,141	17,153	(32,351)		40,943
Valuation allowance against deferred tax asset	1,670,692			5,543,975	7,214,667
	1,726,833	61,158	(57,346)	5,543,975	7,274,620

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements and notes thereto in Item 8 of Part II of this Annual Report on Form 10-K.

(3) Exhibits. The exhibits filed as part of this report are listed under Exhibits at subsection (b) of this Item 15.

(b) Exhibits

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EXHIBIT INDEX

Exhibit No.	Exhibit Document
3.1(1)	Amended and Restated Certificate of Incorporation of the Registrant (Exhibit 3.2)
3.2(2)	Amended and Restated Bylaws of the Registrant (Exhibit 3.4)
4.1(3)	Specimen Common Stock certificate of the Registrant (Exhibit 4.1)
4.2(2)	2003 Stock Plan (Exhibit 10.7)
4.3(4)	2006 Equity Incentive Plan (Exhibit 10.9)
4.4(2)	Form of Senior Convertible Promissory Note (Exhibit 4.2)
4.5(2)	Form of Warrant to Purchase Shares of Common Stock of Luna Innovations Incorporated (Exhibit 4.6)
4.6(2)	Form of Stock Option Agreement (Exhibit 4.7)
4.7(5)	Subordination Agreement, Amendments to Senior Promissory Notes, and Warrant to Purchase Common Stock issued to Carilion Clinic (Exhibit 99.1)
10.1(2)	Form of Indemnification Agreement for directors and executive officers (Exhibit 10.1)
10.2(6)	Employment Agreement by and between the Company and Kent A. Murphy (Exhibit 10.1)
10.3(7)	Employment Agreement by and between the Company and Dale E. Messick (Exhibit 10.1)
10.4(8)	Amended and Restated Employment Agreement by and between the Company and Scott A. Graeff (Exhibit 10.1)
10.5(3)	Amended Loan Agreement, dated as of May 12, 2006, by and between Luna Innovations Incorporated and First National Bank (Exhibit 10.6)
10.6(2)	Amended and Restated Investor Rights Agreement, dated December 30, 2005, by and among Luna Innovations Incorporated, Carilion Health System and certain stockholders (Exhibit 10.8)
10.7(9)	Amended Lease, dated July 20, 2006, by and between Carilion Medical Center and Luna Innovations Incorporated. (Riverside Center, Roanoke, Virginia) (Exhibit 10.1)
10.8(10)	Industrial Lease Agreement, dated March 21, 2006, by and between Luna Innovations Incorporated and the Industrial Development Authority of Montgomery County, Virginia (3157 State Street, Blacksburg, Virginia) (Exhibit 10.27)
10.9(3)	First Amendment to Industrial Lease Agreement, dated May 11, 2006, by and between Luna Innovations Incorporated and the Industrial Development Authority of Montgomery County, Virginia (3150 State Street, Blacksburg, Virginia) (Exhibit 10.34)
10.10(11)	Commercial Lease, dated March 19, 2007, between Canvasback Real Estate & Investments LLC and Luna Innovations Incorporated (705 Dale Avenue, Charlottesville, Virginia) (Exhibit 10.1)
10.11(2)	Full Service Office Lease, dated August 2003, between Hampton R&D Properties, LLC and Luna Innovations Incorporated (130 Research Drive, Hampton, Virginia) (Exhibit 10.15)
10.12(2)	Lease, effective as of January 1, 2005, between the Industrial Development Authority of Danville and Luna Innovations Incorporated (521 Bridge Street, Danville, Virginia) (Exhibit 10.17)
10.13(2)	Grant Agreement, dated March 25, 2004, by and between the City of Danville, Virginia, and Luna Innovations Incorporated (Exhibit 10.21)
10.14(3)	License Agreement No. DN-982, dated June 10, 2002, by and between the National Aeronautics and Space Administration (NASA) and Luna Innovations Incorporated; Modification No. 1 to License Agreement No. DN-982, dated January 23, 2006, by and between NASA and Luna Innovations Incorporated (Exhibit 10.22)

Exhibit No.	Exhibit Document
10.15(3)	License Agreement No. DN-951, dated December 20, 2000, by and between NASA and Luna Technologies, Inc. (Exhibit 10.23)
10.16(3)	License Agreement No. DE-384, dated October 28, 2004, by and between NASA and Luna Technologies, Inc. (Exhibit 10.24)
10.17(3)	Fiber Optic Patent License, dated September 22, 2003, by and between United Technologies Corporation and Luna Innovations Incorporated (Exhibit 10.25)
10.18(3)	Amended and Restated License Agreement, dated March 19, 2004, by and between Virginia Tech Intellectual Properties, Inc. and Luna Innovations Incorporated (Exhibit 10.26)
10.19(12)	Co-Operation Agreement, dated August 10, 2006, by and between Luna Technologies, Inc. and Acterna France SAS. (Exhibit 10.6)
10.20(13)	Asset Transfer and License Agreement by and between Luna Innovations Incorporated and Coherent, Inc. (Exhibit 10.21)
10.21(10)	Form of Stock Sale Restriction Letter Agreement (Exhibit 10.28)
10.22(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Kent A. Murphy, dated as of January 23, 2007. (Exhibit 10.1)
10.23(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Dale E. Messick, dated as of January 23, 2007. (Exhibit 10.2)
10.24(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Scott A. Graeff, dated as of January 23, 2007. (Exhibit 10.3)
10.25(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Robert P. Lenk, dated as of January 23, 2007. (Exhibit 10.4)
10.26(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Scott A. Meller, dated as of January 23, 2007. (Exhibit 10.5)
10.27(14)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Michael F. Gunther, dated as of January 23, 2007. (Exhibit 10.6)
10.28(15)	Development and Supply Agreement by and between Luna Innovations Incorporated and Intuitive Surgical, Inc. dated June 11, 2007 (Exhibit 10.1)
10.29(16)	Second Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Kent A. Murphy, dated as of January 23, 2007. (Exhibit 10.1)
10.30(16)	Second Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Dale E. Messick, dated as of January 23, 2007. (Exhibit 10.2)
10.31(16)	Second Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Scott A. Graeff, dated as of January 23, 2007. (Exhibit 10.3)
10.32(16)	Amended and Restated Stock Sale Restriction Agreement by and between Luna Innovations Incorporated and Robert P. Lenk, dated as of January 23, 2007. (Exhibit 10.4)
10.33(17)	Amended and renegotiated commercial lease by and between Luna Innovations Incorporated and Canvasback Real Estate & Investments LLC dated March 18, 2008 (Exhibit 10.5)
10.34(18)	Loan and Security Agreement between Silicon Valley Bank and Luna Innovations Incorporated dated May 21, 2008 (Exhibit 99.1)
10.35(19)	2008 Senior Management Bonus Plan (Exhibit 10.2)

Exhibit No.	Exhibit Document
10.36	First Amendment to Loan and Security Agreement between Silicon Valley Bank and Luna Innovations Incorporated dated December 31, 2008.
10.37	Non-Employee Director s Deferred Compensation Plan
10.38	2009 Senior Management Incentive Compensation Plan
21.1	List of Subsidiaries
23.1	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm
24.1	Power of Attorney (see signature page)
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated June 2, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
(2) Incorporated by reference to the exhibit to the Registrant s Registration Statement on Form S-1, Commission File No. 333-131764, filed on February 10, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form S-1.
(3) Incorporated by reference to the exhibit to Amendment No. 5 of the Registrant s Registration Statement on Form S-1, Commission File No. 333-131764, filed on April 19, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form S-1.
(4) Incorporated by reference to the exhibit to Amendment No. 3 of the Registrant s Registration Statement on Form S-1, Commission File No. 333-131764, filed on April 28, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form S-1.
(5) Incorporated by reference to the exhibits to the Registrant s Current Report on Form 8-K dated May 27, 2008 (file No. 000-52008). The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
(6) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated July 14, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
(7) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated August 29, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
(8) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated December 20, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
(9) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated July 20, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.

(10) Incorporated by reference to the exhibit to Amendment No. 2 of the Registrant s Registration Statement on Form S-1, Commission File No. 333-131764, filed on April 10, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form S-1.

(11) Incorporated by reference to the exhibit to Registrant s Quarterly Report on Form 10-Q, Commission File No. 000-52008, filed on May 15, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 10-Q.

(12) Incorporated by reference to the exhibit to Registrant s Quarterly Report on Form 10-Q, Commission File No. 000-52008, filed on November 13, 2006. The number given in parentheses indicates the corresponding exhibit number in such Form 10-Q.

(13) Incorporated by reference to the exhibit to Amendment No. 1 to Registrant s Annual Report on Form 10-K, Commission File No. 000-52008, filed on April 6, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 10-K/A.

(14) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated January 23, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.

(15) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated June 11, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.

(16) Incorporated by reference to the exhibit to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated March 3, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.

(17) Incorporated by reference to the exhibit to Registrant s Quarterly Report on Form 10-Q, Commission File No. 000-52008, filed on May 9, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form 10-Q.

(18) Incorporated by reference to the exhibits to the Registrant s Current Report on Form 8-K, Commission File No. 000-52008, dated May 23, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.

(19) Incorporated by reference to the exhibit to Registrant s Quarterly Report on Form 10-Q, Commission File No. 000-52008, filed on August 7, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form 10-Q.

Confidential treatment is requested.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LUNA INNOVATIONS INCORPORATED

By: /s/ KENT A. MURPHY, PH.D.
Kent A. Murphy, Ph.D.

President and Chief Executive Officer

March 13, 2009

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Kent A. Murphy, Ph.D. and Dale E. Messick, and each of them acting individually, as his or her true and lawful attorneys-in-fact and agents, with full power of each to act alone, with full powers of substitution and resubstitution, for him or her and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K with all exhibits thereto and all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, with full power of each to act alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully for all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or his, her, or their substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ KENT A. MURPHY, PH.D. **Kent A. Murphy, Ph.D.**	President, Chief Executive Officer and Director (Principal Executive Officer)	March 13, 2009
/s/ DALE E. MESSICK **Dale E. Messick**	Chief Financial Officer (Principal Financial and Accounting Officer)	March 13, 2009
/s/ N. LEIGH ANDERSON, PH.D. **N. Leigh Anderson, Ph.D.**	Director	March 13, 2009
/s/ JOHN C. BACKUS **John C. Backus**	Director	March 13, 2009
/s/ MICHAEL DANIELS **Michael Daniels**	Director	March 13, 2009
/s/ BOBBIE KILBERG **Bobbie Kilberg**	Director	March 13, 2009

/s/ EDWARD G. MURPHY, M.D.	Director	March 13, 2009
Edward G. Murphy, M.D.		
/s/ RICHARD W. ROEDEL	Director	March 13, 2009
Richard W. Roedel		