LUNA INNOVATIONS INC
Form 10-K/A
April 14, 2010
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 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 000-52008

LUNA INNOVATIONS INCORPORATED

(Exact name of Registrant as Specified in its Charter)

Delaware	54-1560050
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

1 Riverside Circle, Suite 400

Roanoke, VA 24016

(Address of Principal Executive Offices)

(540) 769-8400

(Registrant s Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, par value $0.001 per share	**The NASDAQ Stock Market, LLC**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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.

Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company x
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant on June 30, 2009, based upon the closing price of Common Stock on such date as reported by the NASDAQ Global Market, was approximately $3.1 million.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes x No ¨

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: As of March 23, 2010 there were 12,767,335 shares of the registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Specified portions of the registrant s Proxy Statement with respect to its 2010 Annual Meeting of stockholders, anticipated to be filed within 120 days after the end of its fiscal year ended December 31, 2009, are incorporated by reference into Part III of this annual report on Form 10-K.

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EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (Amendment No. 1) amends the Registrant s Annual Report on Form 10-K, as filed by the Registrant on March 26, 2010 (the Original Filing), and is being filed solely to replace Part II, Item 8. The conforming signature of the Registrant s independent registered public accounting firm was inadvertently omitted from the Report of Independent Registered Public Accounting Firm included with Part II, Item 8 of the Original Filing. The information in this Amendment No. 1 does not otherwise modify or update any of the disclosures in the Original Filing (including the exhibits to the Original Filing), except for the updated certifications attached as exhibits to this Amendment No. 1. In accordance with Rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Amendment No. 1 includes updated certifications from the Registrant s Chief Executive Officer and Chief Financial Officer.

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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 (Debtors-in-Possession) as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in stockholders equity (deficit), and cash flows for each of the three years in the period ended December 31, 2009. 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 (Debtors-in-Possession) as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 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 26, 2010

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CONSOLIDATED BALANCE SHEETS

(Debtor in Possession)

	December 31, 2008	December 31, 2009
Assets		
Current assets		
Cash and cash equivalents	$ 15,518,960	$ 5,228,802
Accounts receivable, net	7,332,034	7,203,203
Refundable income taxes	98,092	
Inventory, net	2,828,991	2,890,364
Prepaid expenses	249,908	560,964
Other current assets	92,690	729,532
Total current assets	26,120,675	16,612,865
Property and equipment, net	5,363,957	4,129,015
Goodwill and intangible assets, net	1,813,643	580,785
Deferred tax asset	600,000	
Other assets	118,292	435,259
Total assets	**$ 34,016,567**	**$ 21,757,924**
Liabilities and stockholders equity (deficit)		
Liabilities not subject to compromise:		
Current Liabilities not subject to compromise;		
Current portion of long term debt obligation	1,428,572	
Current portion of capital lease obligation	17,396	7,510
Accounts payable	2,667,192	1,142,267
Accrued liabilities	5,161,308	3,379,339
Deferred credits	1,854,282	1,027,016
Liabilities not subject to compromise	11,128,750	5,556,132
Long-term debt obligation	8,571,428	
Liabilities subject to compromise		19,062,000
Total liabilities	19,700,178	24,618,132
Commitments and contingencies		
Stockholders equity (deficit):		
Common stock, par value $0.001, 100,000,000 shares authorized, 11,137,882 and 11,351,967 shares issued and outstanding at December 31, 2008 and 2009, respectively	11,138	11,352
Additional paid-in capital	37,960,928	41,228,698
Accumulated deficit	(23,655,677)	(44,100,258)
Total stockholders equity (deficit)	14,316,389	(2,860,208)
Total liabilities and stockholders equity (deficit)	**$ 34,016,567**	**$ 21,757,924**

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

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CONSOLIDATED STATEMENTS OF OPERATIONS

(Debtor in Possession)

	Year ended December 31,		
	2007	**2008**	**2009**
Revenues:			
Technology development revenues	$ 23,356,456	$ 26,838,592	$ 25,322,889
Product and license revenues	10,325,659	10,059,728	9,248,998
Total revenues	33,682,115	36,898,320	34,571,887
Cost of revenues:			
Technology development costs	16,546,140	17,626,495	17,238,571
Product and license costs	4,819,825	5,231,067	4,576,783
Total cost of revenues	21,365,965	22,857,562	21,815,354
Gross profit	12,316,150	14,040,758	12,756,533
Operating expense:			
Selling, general & administrative	16,082,582	17,688,065	16,345,578
Research, development, and engineering	4,487,897	3,646,590	2,874,666
Litigation settlement			9,669,728
Impairment of intangible assets			1,310,598
Total operating expense	20,570,479	21,334,655	30,200,570
Operating loss	(8,254,329)	(7,293,897)	(17,444,037)
Other income (expense):			
Other income, net	32,722	1,197,755	735
Interest income (expense), net	371,991	(189,501)	(503,699)
Total other income (expense)	404,713	1,008,254	(502,964)
Loss before reorganization costs and income tax expense	(7,849,616)	(6,285,643)	(17,947,001)
Reorganization costs			1,897,580
Loss before income tax expense	(7,849,616)	(6,285,643)	(19,844,581)
Income tax expense			600,000
Net loss	$ (7,849,616)	$ (6,285,643)	$ (20,444,581)
Net loss per share:			
Basic	$ (0.77)	$ (0.57)	$ (1.82)
Diluted	$ (0.77)	$ (0.57)	$ (1.82)
Weighted average shares:			
Basic and diluted	10,219,711	10,974,010	11,232,716

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

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

(Debtor in Possession)

	Common Stock		Additional Paid in	Accumulated	
	Shares	$	Capital	Deficit	Total
Balance January 1, 2007	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
Share-based payments	69,220	69	3,216,711		3,216,780
Exercise of options and warrants	144,865	145	51,060		51,204
Net loss				(20,444,581)	(20,444,581)
Balance December 31, 2009	11,351,967	$ 11,352	$ 41,228,698	$ (44,100,258)	$ (2,860,208)

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Debtor in Possession)

	Year ended December 31,		
	2007	**2008**	**2009**
Cash flows used in operating activities:			
Net loss	$ (7,849,616)	$ (6,285,643)	$ (20,444,581)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	1,780,877	1,933,566	1,853,188
Share-based compensation	2,425,143	2,867,487	3,216,780
Deferred tax expense			600,000
Bad debt expense	10,524	(7,161)	135,162
Reogranization costs			826,234
Impairment of intangible assets			1,310,598
Changes in operating assets and liabilities:			
Accounts receivable	(2,493,728)	2,391,737	(6,332)
Inventory	(831,945)	(1,566,809)	(61,373)
Refundable income taxes		297,970	98,092
Other assets	172,740	(59,322)	(1,264,865)
Accounts payable and accrued expenses	1,972,111	(157,628)	259,145
Accrued litigation settlement			9,669,728
Deferred credits	597,724	(172,536)	(827,266)
Net cash used in operating activities	(4,216,170)	(758,339)	(4,635,490)
Cash flows used in investing activities:			
Acquisition of property and equipment	(1,375,612)	(391,210)	(53,111)
Intangible property costs	(414,328)	(536,251)	(642,875)
Net cash used in investing activities	(1,789,940)	(927,461)	(695,986)
Cash flows from financing activities:			
Proceeds from term loan		5,000,000	
Payments on debt obligations	(214,953)		(5,000,000)
Payments on capital lease obligation	(84,695)	(11,160)	(9,886)
Proceeds from the exercise of options and warrants	485,950	168,975	51,204
Net cash from financing activities	186,302	5,157,815	(4,958,682)
Net change in cash	(5,819,808)	3,472,015	(10,290,158)
Cash and cash equivalents beginning of period	17,866,753	12,046,945	15,518,960
Cash and cash equivalents end of period	$ 12,046,945	$ 15,518,960	$ 5,228,802
Supplemental disclosure of cash flow information			
Cash paid for interest	$ 15,340	$ 193,125	$ 177,973
Cash received for income taxes	$	$ 297,970	$ 107,581
Supplemental schedule of non-cash activities			
Warrants issued in connection with debt modification	$	$ 58,194	$
Share issued in lieu of senior management bonus	$	$ 309,216	$

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 , we , or the Company), headquartered in Roanoke, VA 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 technologies that can fulfill identified market needs. We then take these solutions from the applied research stage through commercialization.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (GAAP) and include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. We eliminate from our financial results all significant intercompany transactions. We do not have any investments in entities we believe are variable interest entities for which the Company is the primary beneficiary.

Basis of Presentation

On July 17, 2009, Luna Innovations, along with Luna Technologies, Inc., which comprise substantially all of the operations of the consolidated Company, filed a voluntary petition for relief in order to reorganize under Chapter 11 of the United States Bankruptcy Code, including a proposed plan of reorganization, in the United States Bankruptcy Court for the Western District of Virginia (the Bankruptcy Court). During the period from July 17, 2009 through January 12, 2010, the Company continued to operate its business in the ordinary course as a Debtor-in-Possession. On January 12, 2010, the Bankruptcy Court approved our plan of reorganization, and the Company successfully emerged from Chapter 11.

Due to our status as a Debtor-In-Possession as of December 31, 2009, the accompanying financial statements are presented in accordance with Accounting Standards Codification (ASC) 852-10-45, Reorganizations- Overall- Other Presentation Matters. Accordingly, liabilities subject to compromise as of December 31, 2009, which include the expected allowed claims for liabilities incurred prior to our Chapter 11 filing, are presented separately from those liabilities not subject to compromise on our Consolidated Balance Sheet. Liabilities not subject to compromise include all liabilities incurred after the Chapter 11 petition date. All liabilities incurred prior to the petition date are considered liabilities subject to compromise. These amounts represent the Company s estimates of known or potential pre-petition date claims that are likely to be resolved in connection with the Chapter 11 filings. In addition, those expenses directly attributable to our Chapter 11 activities, including, but not limited to, professional fees, mailings to creditors, and fees payable to the United States Trustee, are presented separately from other operating expenses on our Consolidated Statement of Operations as reorganization expense.

In connection with our litigation settlement, upon our emergence from Chapter 11 in January 2010, we issued approximately 1.2 million shares of common stock to Hansen Medical, Inc. Other outstanding shares of common stock were not impacted as a result of our reorganization activities. Because the shareholders immediately prior to our emergence from Chapter 11 continue to own more than 50% of the total outstanding common stock immediately following our emergence from Chapter 11, we will not be required to adopt the fresh-start reporting principles of ASC 852-10-45.

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Going Concern

As noted above, on July 17, 2009, we filed a voluntary petition for relief in order to reorganize under the Bankruptcy Code. On January 12, 2010 the Company successfully emerged from Chapter 11. On February 18, 2010 the Company entered into a $5 million revolving credit facility as further described in Note 16. The Company believes that following its emergence from Chapter 11 and execution of its new credit facility it has adequate liquidity and resources to meet its ongoing operating needs in the ordinary course of business, and, therefore, the accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern.

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 costs that are determined to be reasonable, allowable and allocable to the contract and paid a fixed fee representing the profit negotiated between us and the contracting agency. 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. 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 as this method more accurately measures performance under these arrangements. Losses on contracts, if any, are recognized in the period in which they become known.

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. 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

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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 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 persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable, and collectability of the resulting receivable is reasonably assured. 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 item 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. 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.

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. To date, the Company has not incurred losses related to cash and cash equivalents.

Fair Value Measurements

The Company s financial assets and liabilities are measured at fair value, which is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. Valuation techniques are based on observable or unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. These two types of inputs have created the following fair value hierarchy:

Level 1 Quoted prices for identical instruments in active markets.

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Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant value drivers are observable.

Level 3 Valuations derived from valuation techniques in which significant value drivers are unobservable.

The carrying values of cash and cash equivalents, contract receivables and accounts payable approximate fair value because of the short-term nature of these instruments. The carrying value of the promissory notes approximate fair value as the interest rate is equal to the interest rate on our new credit facility with Silicon Valley Bank, established in February 2010.

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 allocate goodwill to the appropriate reporting unit and test for impairment using a two-step approach. We amortize our patents over their estimated useful life of five years, and analyze them whenever events or circumstances indicate that the carrying amount may not be recoverable to determine whether their carrying value has been impaired.

We perform a goodwill impairment test annually, on December 31st, or whenever an event has occurred that would more likely than not reduce the fair value of a reporting unit below its carrying amounts. Following the verdict in the Hansen litigation, which resulted in the Company recording a reserve of $36.3 million in the first quarter of 2009, we determined that the expected future cash flows for our product and license reporting unit were less than the carrying amount of the reporting unit and, accordingly, we recorded an impairment charge of $1.3 million to fully write off the goodwill and other intangible assets related to that reporting unit.

Research and Development

Research and development costs not related to contract performance are expensed as incurred. We expensed $4.5 million, $3.5 million and $2.9 million of non-contract related research and development expenses for the years ended December 31, 2007, December 31, 2008, and December 31, 2009, respectively.

Capitalized Software Costs

We did not capitalize any software development costs during the three years ended December 31, 2009. 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.

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Valuation of Long-Lived Assets

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets 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 carrying value of the inventory and the estimated market value based upon assumptions about future demand and market conditions. Inventory reserves at December 31, 2008 and 2009 were $43,427 and $47,757, respectively.

Net Loss 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, 4,871,514 and 4,613,006 common stock equivalents (which include outstanding warrants and stock options) are not included for the years ended December 31, 2007, 2008 and 2009 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 9. We recognize compensation expense based upon the fair value of the underlying equity award as of the date of grant. The Company has elected to use the Black-Scholes option pricing model to value any awards granted. 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.

The Company recognizes expense for equity instruments issued to non-employees based upon the fair value of the equity instruments issued.

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:

	2007	2008	2009
Risk-free interest rate range	4.27% 4.77%	2.18% 4.02%	2.80% 3.17%
Expected life of option-years	7.5	7.5	7.5
Expected stock price volatility	56.80%	63% 83%	83% 117%
Expected dividend yield			

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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 year ended December 31, 2007, 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 years ended December 31, 2008 and 2009, 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.

Advertising

We expense the cost of advertising as incurred. Historically such amounts have not 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 recognize tax benefits from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by taxing authorities.

Recent Accounting Pronouncements

Effective July 1, 2009, the Company adopted *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (ASC 105). This standard establishes only two levels of GAAP, authoritative and nonauthoritative. The FASB Accounting Standards Codification (the Codification) became the source of authoritative, nongovernmental GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the Codification became nonauthoritative. The Company began using the new guidelines and numbering system prescribed by the Codification when referring to GAAP in the third quarter of fiscal 2009. As the Codification was not intended to change or alter existing GAAP, it did not have any impact on the Company s Consolidated Financial Statements.

In September 2009, the FASB issued Accounting Standard Update No. 2009-13, Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force (ASU 2009-13). It updates the existing multiple-element revenue arrangements guidance currently included under ASC 605-25. The revised guidance primarily provides two significant changes: 1) requires an entity to allocate revenue in an arrangement using estimated selling prices (ESP) of deliverables if a vendor does not have vendor-specific objective evidence of selling price (VSOE) or third-party evidence of selling price (TPE); and 2) eliminates the residual method and requires an entity to allocate revenue using the relative selling price method. The Company adopted this new accounting guidance starting January 2010 on a prospective basis for applicable transactions originating or materially modified after December 31, 2009. This guidance does not generally change the units of accounting for the Company s revenue transactions. The company does not expect the adoption of ASU 2009-13 to have a significant impact on its financial results.

Effective April 1, 2009, the Company adopted two accounting standard updates which were intended to provide additional application guidance and enhanced disclosures regarding fair value measurements and impairments of securities. They also provide additional guidelines for estimating fair value in accordance with fair value accounting. The first update, as codified in ASC 820-10-65, provides additional guidelines for estimating fair value in accordance with fair value accounting. The second accounting update, as codified in ASC 825-10-65, requires fair value disclosures in the interim periods as well as in the annual financial statements.

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These updates were effective for fiscal years and interim periods ended after June 15, 2009. The adoption of these accounting updates did not have any impact on the Company s Consolidated Financial Statements.

Effective April 1, 2009, the Company adopted a new accounting standard for subsequent events, as codified in ASC 855-10. The update modifies the names of the two types of subsequent events either as recognized subsequent events (previously referred to in practice as Type I subsequent events) or non-recognized subsequent events (previously referred to in practice as Type II subsequent events). In addition, the standard modifies the definition of subsequent events to refer to events or transactions that occur after the balance sheet date, but before the financial statements are issued (for public entities) or available to be issued (for nonpublic entities). The update did not result in significant changes in the practice of subsequent event disclosures, and therefore the adoption did not have any impact on the Company s Consolidated Financial Statements.

Reclassifications

Certain reclassifications have been made to the 2007 financial statements to conform to the 2008 and 2009 presentation. Specifically, operating expenses have segregated between selling, general & administrative and research, development and engineering within the Consolidated Statement of Operations.

2. Litigation and Agreements with Hansen Medical, Inc.

On June 22, 2007, Hansen Medical Inc. (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 alleged 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, and fraud. In addition to money damages in an unspecified amount, Hansen sought, 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., (Intuitive) or otherwise.

We also filed a counterclaim against Hansen and an amended counterclaim on March 18, 2008 asserting 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. However, we subsequently withdrew all of our counterclaims prior to the matter proceeding to trial on the merits in March 2009.

Prior to and during the course of the trial, Hansen s claims for conversion, unfair competition, aiding and abetting breach of fiduciary duty and intentional interference with contract were all dismissed. Hansen s remaining claims for misappropriation of trade secrets, breach of contract, breach of implied covenant of good faith and fair dealing and fraud were submitted to a jury following a trial on the merits that concluded in April 2009. On April 21, 2009, a jury found in favor of Hansen on its breach of contract, breach of the covenant of good faith and fair dealing and misappropriation of trade secrets claims, and it awarded a verdict for $36.3 million against us. The jury did not find in favor of Hansen on its fraud claims against us, but it did find that our misappropriation was willful or malicious. We recorded a reserve for the full amount of the jury award in the quarter ended March 31, 2009.

On December 11, 2009, Luna Innovations and its wholly-owned subsidiary, Luna Technologies, Inc. (together with Luna Innovations, the Companies) entered into a Confidential Settlement Agreement (the Settlement Agreement) to settle all claims arising out of the litigation with Hansen. As a result of the settlement our accrual of $36.3 million recorded during the quarter ended March 31, 2009 was adjusted to $9.7 million at December 31, 2009. On January 12, 2010, the Companies entered into a series of agreements with Hansen and Intuitive that were contemplated by the Settlement Agreement. The material terms of these agreements are summarized below.

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License Agreement between the Companies and Hansen (the Hansen License)

Under the Hansen License, the Companies granted Hansen (i) a co-exclusive (with Intuitive), royalty-free, fully paid, perpetual and irrevocable license to the Companies fiber optic shape sensing/localization technology within the medical robotics field. The license can only be sublicensed by Hansen in connection with Hansen products, except that Hansen can grant full sublicenses to third parties for single degree of freedom robotic medical devices; (ii) an exclusive (and fully sublicenseable) royalty-free, fully paid, perpetual and irrevocable license to the Companies fiber optic shape sensing/localization technology for non-robotic medical devices within the orthopedics, vascular, and endoluminal fields; and (iii) a co-exclusive (with the Companies) royalty-free, fully paid, perpetual and irrevocable license to the Companies fiber optic shape sensing/localization technology for non-robotic medical devices in other medical fields (including colonoscopies but not including devices described in clause (ii) above). After five years, the exclusive license in the non-robotic endoluminal field may be converted to a co-exclusive (with the Companies) license in certain circumstances in connection with certain supply provisions applicable to that field under the Development and Supply Agreement (as defined below).

The Hansen License provides that Hansen and Intuitive have the right to enforce the intellectual property licensed by the Companies within the medical robotics field. Hansen has the sole right to enforce such intellectual property for non-robotic devices in the orthopedics field, the vascular field and the endoluminal field. The Companies have the right to enforce such intellectual property in other non-robotic medical fields.

In addition, Hansen granted the Companies a nonexclusive, sublicenseable, royalty-free, fully paid, perpetual and irrevocable license to certain Hansen fiber optic shape sensing/localization technology in all fields outside of the medical robotics field and the orthopedics, vascular and endoluminal fields. Furthermore, the Companies confirmed Hansen s ownership of certain intellectual property developed in whole or in part by the Companies under a prior agreement between the Companies and Hansen.

Note Payable from Luna Innovations to Hansen

In connection with the Settlement Agreement, the Company issued a promissory note (the Hansen Note) in the principal amount of $5.0 million payable in 16 quarterly installments beginning April 2010. The note bears interest at a fixed rate of 8.5% and is secured by substantially all of the assets of the Company. The Hansen Note is subordinated to the Company s primary bank credit facility, with Silicon Valley Bank, that was entered into February 2010.

Common Stock Issued to Hansen

In connection with the Settlement Agreement, on January 12, 2010, the Company issued 1,247,330 shares of common stock to Hansen, representing 9.9% of the then outstanding common stock of the Company. In addition, the Company issued to Hansen a warrant entitling Hansen to purchase, until January 12, 2013, a number of shares of common stock as necessary for Hansen to maintain a 9.9% ownership interest in the Company s common stock, at an exercise price of $0.01 per share.

Development and Supply Agreement

In connection with the Settlement Agreement, the Company also entered into a development and supply agreement with Hansen. Under the terms of this agreement, the Company will perform product development services with respect to fiber optic shape sensing at Hansen s request and provide Luna shape sensing products to

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Hansen. Revenues earned for product development will be determined in a manner consistent with the Company s contract development services in its Technology Development business segment and will be payable monthly to Luna. To the extent such revenues exceed the quarterly installment payment owed by the Company to Hansen under the Hansen Note, then such excess will not be payable in cash and instead will be credited against the outstanding principal balance of the Hansen Note.

As of December 31, 2009, the Company has reflected the $5.0 million principal amount of the Hansen Note issued in January 2010 and approximately $4.7 million for the common stock issued to Hansen in January 2010, based on the closing price of the Company s common stock on the date of issuance, as the remaining Litigation Reserve in the accompanying consolidated financial statements. There was no value assigned to the development and supply agreement.

3. Accounts Receivable Trade

Accounts receivable consist of the following at:

	December 31,	
	2008	**2009**
Billed	$ 5,158,101	$ 5,455,419
Unbilled	2,162,830	1,894,455
Other	33,476	10,864
	$ 7,354,407	$ 7,360,738
Less: allowance for doubtful accounts	(22,373)	(157,535)
	$ 7,332,034	$ 7,203,203

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 $1.2 million and less than $0.1 million for the years ended December 31, 2008 and 2009, respectively, and are recorded as deferred revenue until earned. Contract retainage amounts were $0.5 million and $0.2 million for the years ended December 31, 2008 and 2009, respectively, and are recorded as unbilled accounts receivable until final settlement of the underlying contracts.

Unbilled amounts are expected to be billed in future periods and are classified as current assets in accordance with industry practice.

4. Property and Equipment

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

	December 31,	
	2008	**2009**
Equipment	$ 6,188,850	$ 6,177,166
Furniture and fixtures	621,776	621,776
Software	1,170,767	1,170,767
Leasehold improvements	3,255,589	3,257,303
	11,236,982	11,227,012

Less accumulated depreciation	(5,873,025)	(7,097,996)
	$ 5,363,957	$ 4,129,015

Depreciation for the years ended December 31, 2007, 2008, and 2009 was approximately $1.3 million, $1.3 million, and $1.2 million, respectively.

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5. Intangible Assets

The following is a summary of intangible assets:

	December 31, 2008	December 31, 2009
Goodwill	$ 418,075	$
Patent costs	2,002,975	1,774,871
Other capitalized intellectual property rights	742,667	
Accumulated amortization	(1,350,074)	(1,194,086)
	$ 1,813,643	$ 580,785

Amortization for the periods ended December 31, 2007, 2008, and 2009 was approximately $0.5 million, $0.6 million, and $0.6 million, respectively. In 2009 we recorded an impairment charge against our goodwill of $0.4 million, and an impairment charge of $0.9 million related to intellectual property assets in our product and license business unit, as the carrying values exceeded the fair value as determined through a discounted cash flow analysis for goodwill and an undiscounted cash flow analysis for our intellectual property.

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

Year Ended December 31,	
2010	$ 162,106
2011	134,968
2012	106,877
2013	92,697
2014	84,137
	$ 580,785

6. Liabilities Subject to Compromise

Liabilities Subject to Compromise consist of the following at:

	December 31, 2008	December 31, 2009
Accounts payable	$	$ 1,074,188
Accrued liabilities		3,318,084
Notes payable		5,000,000
Litigation settlement		9,669,728
Liabilities subject to compromise		$ 19,062,000

7. Debt Agreements

Silicon Valley Bank Facility

On May 21, 2008, we entered into a $10.0 million maximum debt facility with Silicon Valley Bank. Included in this facility was a four-year term loan of $5.0 million and a revolving line of credit facility available for the remaining unused balance. As part of the facility, Silicon Valley Bank issued a letter of credit on our behalf to the Industrial Development Authority of Montgomery County, Virginia, as required under an office lease. At December 31, 2008, the full principal amount of $5.0 million was outstanding under the term loan, and there was no outstanding balance under the revolving line of credit facility.

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As a result of the jury verdict awarded against us in connection with the Hansen litigation in April 2009, we were not in compliance with certain of the financial covenants associated with the term loan and the revolving line of credit. In June 2009, Silicon Valley Bank agreed to forebear on the declaration of a default through July 17, 2009. On July 15, 2009, we repaid the outstanding balance of the term loan in full and terminated the credit facility.

Carilion Promissory Note

In 2005, we issued $5.0 million in principal amount of convertible promissory notes to Carilion Clinic (Carilion) that were convertible into shares of our Common Stock at a fixed price of $4.69 per share. The notes accrued simple interest at a rate of 6.0% per year and were originally scheduled to mature on December 30, 2009.

In May 2008, we amended the terms of the notes to extend their due date to December 31, 2012 and to subordinate them to our credit facility with Silicon Valley Bank. We also issued warrants to purchase 10,000 shares of Common Stock at a price of $7.98 per share in connection with the amended terms. We valued the warrants using the Black-Scholes option pricing model, and we were amortizing the value as a deferred financing cost over the life of the promissory notes.

Long-term debt obligations at December 31, 2008, and liabilities subject to compromise at December 31, 2009, include the full $5.0 million principal amount payable to Carilion. Our bankruptcy filing on July 17, 2009 constituted an event of default under Section 4(b) of the Carilion notes, which accelerated the maturity date; as such, the Carillion notes are included in current liabilities at December 31, 2009.

On January 12, 2010, we exchanged the convertible notes for 1,321,514 shares of convertible preferred stock in full satisfaction of the $5.0 million principal amount due under the convertible notes and $1.2 million in accrued but unpaid interest under the notes. In addition, the warrants issued in May 2008 to purchase 10,000 shares of Common Stock were amended to reduce their strike price to $2.50 per share. As part of the exchange, the company also issued additional warrants to Carilion to purchase an aggregate of 356,000 shares of Common Stock with a strike price of $2.50. The warrants are exercisable beginning December 31, 2012 and February 1, 2013, respectively, and continuing until December 31, 2020.

The following table presents a summary of debt.

	December 31,	
	2008	2009
Carilion Clinic convertible promissory note	$ 5,000,000	$ 5,000,000
Silicon Valley Bank Term Loan	5,000,000	
	$ 10,000,000	$ 5,000,000
Less: currently payable	1,428,572	
Less: Amounts subject to compromise		5,000,000
Total long-term debt	$ 8,571,428	$

Costs associated with loans outstanding were as follows:

	Years Ended December 31,		
	2007	2008	2009
Interest expense	$ 318,480	$ 500,311	$ 439,233
Amortization of transaction costs	$	$ 10,478	$ 78,248
Total interest expense	$ 318,480	$ 510,789	$ 517,482

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8. Income Taxes

Deferred tax assets and liabilities consist of the following components:

	December 31,	
	2008	2009
Research and development credits	$ 386,161	$ 386,161
Net operating loss carryforwards	7,745,382	12,360,030
Accrued liabilities	491,277	821,360
Stock-based compensation	615,902	847,282
Depreciation and amortization	438,121	290,262
Bad debt and inventory reserve	20,828	77,929
	9,697,671	14,783,024
Valuation allowance	(9,097,671)	(14,783,024)
Net deferred tax asset	$ 600,000	$ 0

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

	2007	2008	2009
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	1.69%	1.48%	0%
Change in valuation allowance	(7.78%)	(20.24%)	(31.12%)
Permanent differences and other	(31.87%)	(19.20%)	(9.85%)
Income tax (expense)	0.00%	0.00%	(3.01%)

The income tax expense consists of the following for:

	2007	2008	2009
Current:			
Federal	$	$	$
State			
Deferred Federal			600,000
Deferred State			
Income tax expense	$	$	$ 600,000

The realization of our deferred income tax assets is dependent upon sufficient taxable income in future periods. 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 forwards at December 31, 2009 of approximately $32.3 million expiring at varying dates through 2027. We have research & development tax credit carry forwards at December 31, 2009 of approximately $0.4 million, which expire at varying dates through 2026.

A tax benefit asset $600,000 was recorded at December 31, 2008, based upon management s assessment that as of that date it was more likely than not that this portion of the entire deferred tax benefit would be realized in future periods. Our assessment was based on a projection of the amount of federal taxable income that we estimated would be generated in future years, as well as an analysis of certain other evidentiary

indicators, notably, that operating expenses had declined as a proportion of revenue for each year that we have been public,

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and our annual net loss had regularly declined. In the first quarter of 2009 the company determined that the tax benefit was no longer more-likely-than-not to be realized considering the impact of the accrued costs associated with the Hansen litigation among other things, and accordingly provided a full valuation allowance for the balance of the deferred tax asset.

We are regularly examined by federal and various state tax authorities. The U.S. federal statute of limitations remains open for the year 2003 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.

9. Stockholders Equity

Warrants

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 capitalized as a prepaid financing charge and was being amortized over the life of the debt. As discussed in Note 2, subsequent to December 31, 2009 and in connection with the conversion of the notes, the strike price of these warrants was reduced to $2.50 per share, and an additional warrant to purchase 356,000 shares of our common stock at an exercise price of $2.50 per share was also issued to Carilion. The Company recorded a charge to interest expense in 2010 for the difference between the fair value of the warrant immediately before modification and the fair value of the warrant immediately after modification.

Stock Option Plans

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. There were options outstanding under the 2003 Plan to purchase an aggregate of 2,243,455 shares as of December 31, 2009. Following 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 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 options and restricted stock awards to employees, directors, and consultants of our Company to purchase common stock. Awards generally have a life of 10 years and exercise prices equal to the closing price of our common stock on the date of the option grant. On January 1 of 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 last day of the preceding fiscal year; (b) 1,695,690 shares; or (c) such other amount as our board of directors may determine. A total of 6,777,640 and 6,966,886 shares were available for future grant under the 2006 Plan as of December 31, 2008 and 2009, respectively.

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Vesting typically occurs over a five-year period.

Total non-cash stock option expense for the years ended December 31, 2007, 2008 and 2009 was $2.4 million, $2.9 million and $3.2 million, respectively.

The following table sets forth the activity of the options to purchase common stock under the 2003 Plan and the 2006 Plan:

	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, 2007	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
Forfeited	(733,519)	0.35 8.20	5.45				
Exercised	(144,717)	0.35	1.36				
Granted	805,150	2.11 8.04	6.14				
Balance at December 31, 2009	4,727,360	0.35 8.20	2.43	$ 3,545,705	2,987,955	$ 1.72	$ 2,734,841

(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 or NASDAQ Capital Market, as applicable, 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, 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
Year ended December 31, 2009	$ 0.35 $8.20	4,727,360	6.8	$ 2.43	2,987,955	$ 1.72

The following table sets forth information regarding the weighted average grant-date fair value, for non-stock option equity instruments we issued during 2009:

	Number of Shares	Weighted-average grant date fair value
Non-vested at January 1, 2009	10,000	$ 5.82
Non-vested at December 31, 2009	10,000	5.82
Granted during 2009	100,655	0.81

Vested during 2009	100,655	0.81
Forfeited during 2009		

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

	Total intrinsic value of options exercised	Total fair value of options vested
Year ended December 31, 2007	3,550,911	
Year ended December 31, 2008	1,910,675	1,573,725
Year ended December 31, 2009	145,119	2,550,070

For the years ended December 31, 2007, 2008, and 2009, the weighted average grant date fair value of options granted was $3.01, $4.13, and $0.74, respectively. We estimate the fair value of options at the grant date using the Black-Scholes model.

We recognized $3.2 million in share-based payment expense which is recorded in selling, general and administrative expenses on the Statement of Operations for the year ended December 31, 2009, and we will recognize $5.6 million over the remaining requisite service period. For all options granted through December 31, 2009, the weighted average remaining service period is 2.0 years.

10. Commitments and Contingencies

Obligation Under Operating Leases

We lease facilities in Blacksburg, Charlottesville, Danville, McLean, and Roanoke, Virginia under operating leases that expire between June 2011 and December 2015. Certain of the leases are subject to fixed escalations and provide for possible termination prior to their expiration dates. We recognize rent expense on such leases on a straight-line basis over the lease term. Rent expense under these leases was approximately $1.4 million, $1.3 million and $1.2 million for the years ended December 31, 2007, 2008, and 2009 respectively.

In March 2009 we cancelled our lease in Hampton, Virginia.

We are obligated under operating leases covering certain equipment that expire at various dates during the next two years.

Minimum future rentals, as of December 31, 2009, under the aforementioned operating leases for each of the next five periods ending are:

2010	1,403,829
2011	1,451,559
2012	381,417
2013	8,649
	$ 3,245,454

We subleased our McLean facility during 2008. We will receive future payments of $112,885 during the remaining life of the sublease.

New Facility Lease

We amended the lease for our Charlottesville facility, which now expires in December 2015. This lease is cancellable at the end of 2010 without penalty. Since we include only minimum payments in the table above, we do not include any amounts after 2010 for the Charlottesville facility lease.

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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 was to be used to offset certain capital expenditures for leasehold improvements being made at our Danville facility. The remaining $450,000 was 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.

During 2009 we earned an additional approximately $35,000 under the Grant. In January 2010, we agreed to pay back approximately $108,000 of the Grant in quarterly installments over the next five years, ending in November 2014. We currently have up to approximately $89,000 available to earn under the Grant in future periods, although this amount may be reduced in whole or in part by the City of Danville.

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, 2009, approximately $1.0 million of this commitment remained. The delivery of the remaining lasers has been agreed to be extended to 21 months through June 2010.

Royalty Agreement

We have licensed certain third-party technologies from vendors for which we owe minimum royalties aggregating $2.0 million payable over the remaining patent terms of the underlying technology.

11. 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 contributed 25% of the salary deferral elected by each employee up to a maximum deferral of 10% of annual salary.

We contributed approximately $0.5 million, $0.5 million and $0.25 million to the plan for the years ended December 31, 2007, 2008, and 2009 respectively.

12. 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.

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A description of our litigation with Hansen that we settled in December 2009 is included in Note 2 above.

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. In December 2009 we agreed to settle this matter in exchange for the payment of $13,000 in cash and the issuance of 25,000 shares of our common upon our emergence from bankruptcy. We have included the settlement of cash and the value of the common stock at $3.66, which represented the closing price the day before we emerged from bankruptcy in January 2010, in accrued liabilities on the accompanying consolidated balance sheet at December 31, 2009.

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.

13. Relationship with Major Customers

During the years ended December 31, 2007, 2008 and 2009, approximately 68%, 73% and 76%, respectively, of our consolidated revenues were attributable to contracts with the U.S. government.

At December 31, 2008 and 2009, receivables with respect to contracts with the U.S. government represented 75% and 71% 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.

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.

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There were no significant inter-segment sales during the three years ended December 31, 2009. There was an insignificant amount of product sales made outside the United States during these three years.

	Twelve Months Ended Dec 31,		
	2007	2008	2009
Technology Development revenue	$ 23,356,456	$ 26,838,592	$ 25,322,889
Product and License revenue	10,325,659	10,059,728	9,248,998
Total revenue	33,682,115	36,898,320	34,571,887
Technology Development operating loss	(3,898,626)	(1,322,542)	(4,317,229)
Product and License operating loss	(4,355,703)	(5,971,355)	(15,024,388)
Total operating loss	$ (8,254,329)	$ (7,293,897)	$ (19,341,617)
Depreciation, Technology Development	$ 864,156	$ 945,450	$ 943,460
Depreciation, Product and License	382,035	354,376	344,592
Amortization, Technology Development	370,772	460,961	413,946
Amortization, Product and License	163,914	172,779	151,191

Additional segment information is as follows:

	December 31,	
	2008	2009
Total segment assets:		
Technology Development	$ 26,559,928	$ 15,937,039
Product and License	7,456,639	5,820,885
Total	$ 34,016,567	$ 21,757,924
Property plant and equipment, goodwill, and intangible assets, Technology Development	$ 5,220,744	$ 3,449,790
Property plant and equipment, goodwill, and intangible assets, Product and License	$ 1,956,856	$ 1,260,010

15. Quarterly Results (unaudited)

The following table sets forth our unaudited historical revenues, operating (loss) income and net (loss) income by quarter during 2008 and 2009:

	Quarter Ended							
(Dollars in thousands, except per share amounts)	**Mar. 31, 2008**	**Jun. 30, 2008**	**Sep. 30, 2008**	**Dec. 31, 2008**	**Mar. 31, 2009**	**Jun. 30, 2009**	**Sep. 30, 2009**	**Dec. 31, 2009**
Revenues:								
Technology	$ 6,602	$ 6,947	$ 7,247	$ 6,043	$ 6,882	$ 6,447	$ 6,538	$ 5,456
Product and license	2,318	2,931	3,457	1,354	1,611	2,215	2,337	3,086
Total revenues	8,920	9,878	10,704	7,397	8,494	8,662	8,875	8,542
Gross Margin	3,382	4,069	4,267	14,029	2,717	3,342	3,507	12,747

Operating income (loss)	(1,876)	(1,765)	(1,105)	(2,544)	(40,128)	(2,250)	(1,046)	25,981
Net (loss) Income	$ (1,852)	$ (1,798)	$ (473)	$ (2,161)	$ (40,888)	$ (2,407)	$ (2,043)	$ 24,894
Net (loss) Income per share:								
Basic	$ (0.17)	$ (0.16)	$ (0.04)	$ (0.19)	$ (3.66)	$ (0.21)	$ (0.18)	$ 2.20
Diluted	$ (0.17)	$ (0.16)	$ (0.04)	$ (0.19)	$ (3.66)	$ (0.21)	$ (0.18)	$ 2.01
Weighted average shares:								
Basic	10,781,363	10,935,370	11,055,613	11,118,249	11,161,423	11,207,021	11,247,749	11,313,255
Diluted	10,781,363	10,935,370	11,055,613	11,118,249	11,161,423	11,207,021	11,247,749	12,395,468

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16. Subsequent Events

On January 12, 2010, we emerged from bankruptcy in accordance with our plan of reorganization. Under the reorganization plan as approved by the Bankruptcy Court, we expect to pay 100% of all valid pre-petition claims, and we did not reject any of our then-existing executory contracts. Additionally, we and Hansen settled our litigation and entered into a number of agreements, as described in Note 2.

On January 12, 2010, we issued 1,321,514 shares of convertible preferred stock to Carilion in full satisfaction of our obligations to Carilion under of the outstanding convertible promissory notes in principal amount of $5.0 million, plus accrued but unpaid interest of approximately $1.2 million. The newly designated convertible preferred stock carries a 6% dividend, which is payable in additional shares of preferred stock, and may be converted at any time into shares of our common stock at a price of approximately $4.67 per share.

On February 18, 2010, we entered into a Loan and Security Agreement (the Credit Facility) with Silicon Valley Bank (SVB). The Credit Facility is a revolving credit facility that provides us with borrowing capacity of up to $5.0 million at a floating annual interest rate equal to the greater of (a) 6% or (b) SVB s prime rate then in effect plus 2%. The Credit Facility matures on February 17, 2011, unless earlier terminated, and any amounts outstanding under the Credit Facility will be secured by substantially all of our assets, including our intellectual property, personal property and bank accounts. The Credit Facility includes a fee of one-half of one percent (0.50%) per annum based on the average unused portion of the Credit Facility.

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EXHIBIT INDEX

Exhibit No.	Exhibit Document
23.1	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm (included with Original Filing).
24.1	Power of Attorney (included on signature page to Original Filing).
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.

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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 Amendment No. 1 to Annual Report on Form 10-K for the year ended December 31, 2009 to be signed on its behalf by the undersigned thereunto duly authorized.

LUNA INNOVATIONS INCORPORATED

By: /S/ KENT A. MURPHY
Kent A. Murphy, Ph.D.
President and Chief Executive Officer
April 14, 2010