
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): February 9, 2015

Luna Innovations Incorporated

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation)

000-52008
(Commission
File Number)

54-1560050
(IRS Employer
Identification No.)

1 Riverside Circle, Suite 400
Roanoke, Virginia 24016
(Address of principal executive offices, including zip code)

540-769-8400
(Registrant's telephone number, including area code)

(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
 - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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Item 8.01. Other Events.

Luna Innovations Incorporated, or Luna, is retrospectively revising its historical financial statements to account for discontinued operations in connection with the Accounting Standards Codification (ASC) 205-20, "Presentation of Financial Statements-Discontinued Operations." As previously disclosed, on January 21, 2014, Luna sold its assets associated with the development of fiber optic shape sensing and localization for the medical field, or the medical shape sensing business, for an aggregate purchase price of approximately \$30.0 million pursuant to an asset purchase agreement. This Current Report on Form 8-K updates the following items in Luna's Annual Report on Form 10-K for the year ended December 31, 2013, as amended, to reflect retrospectively the changes resulting from discontinued operations discussed above for the years ended December 31, 2012 and 2013:

- Item 6. Selected Financial Data;
- Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations; and
- Item 8. Financial Statements and Supplementary Data.

Luna has not presented updated selected financial data for the years ended December 31, 2009, 2010 or 2011, nor has Luna presented consolidated financial statements and accompanying footnotes for the year ended December 31, 2011, as management has assessed the materiality of recasting these disclosures for such years, both quantitatively and qualitatively, and concluded that updating these disclosures with respect to discontinued operations associated with the sale of the medical shape sensing business for such years is not material to any of Luna's previously issued or current year financial statements.

The information included in this Current Report on Form 8-K should be read in conjunction with Luna's Annual Report on Form 10-K for the year ended December 31, 2013, as amended, and Quarterly Reports on Form 10-Q for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014.

Item 9.01. Financial Statements and Exhibits.**(d) Exhibits**

<u>Exhibit Number</u>	<u>Exhibit Description</u>
23.1	Consent of Grant Thornton LLP
99.1	Updated Selected Financial Data
99.2	Updated Management's Discussion and Analysis of Financial Condition and Results of Operations
99.3	Updated Consolidated Financial Statements and Notes to the Consolidated Financial Statements
99.4	Updated Schedule II
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Calculation Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Calculation Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Calculation Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

Luna Innovations Incorporated

By: /s/ Talfourd H. Kemper, Jr.
Talfourd H. Kemper, Jr.
Vice President and General Counsel

Date: February 9, 2015

EXHIBIT INDEX

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CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have issued our report dated April 10, 2014 (except for Note 15, as to which the date is February 9, 2015), with respect to the consolidated financial statements and financial statement schedule included in this Current Report on Form 8-K of Luna Innovations Incorporated. We hereby consent to the incorporation by reference of said report in the Registration Statements of Luna Innovations Incorporated on Form S-3 (File No. 333-191809) and on Form S-8 (File No. 333-138745).

/s/ Grant Thornton LLP

McLean, Virginia
February 9, 2015

EXPLANATORY NOTE

Luna Innovations Incorporated (“Luna,” the “Company,” “we” or “us”) is retrospectively revising its historical financial statements to account for discontinued operations in connection with the Accounting Standards Codification (ASC) 205-20, “Presentation of Financial Statements-Discontinued Operations.” As previously disclosed, on January 21, 2014, Luna sold substantially all of the assets comprising its medical shape sensing business to Intuitive Surgical, Inc. for total consideration of up to \$30.0 million pursuant to an asset purchase agreement.

The exhibits to this Current Report on Form 8-K update the following items in the Company’s Annual Report on Form 10-K as amended, for the year ended December 31, 2013 (the “2013 10-K”) to reflect retrospectively the changes resulting from discontinued operations discussed above for the years ended December 31, 2012 and 2013:

- Item 6. Selected Financial Data;
- Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations; and
- Item 8. Financial Statements and Supplementary Data. The following Notes to Consolidated Financial Statements were impacted by our reclassification of the revenue and costs associated with our medical shape sensing business to discontinued operations.
 - Note 1. Organization and Summary of Significant Accounting Policies.
 - Note 12. Relationship with Major Customers.
 - Note 13. Financial Information About Segments.
 - Note 14. Quarterly Results.
 - Note 15. Discontinued Operations.

Other than the items listed above, the Company is not otherwise updating any other portion of the 2013 10-K. Unaffected items of the 2013 10-K have not been repeated in this Current Report on Form 8-K. This Current Report on Form 8-K does not modify or update the disclosures contained in the 2013 10-K in any way, nor does it reflect any subsequent information, activities or events, other than as required to reflect discontinued operations described above. Without limitation to the foregoing, this Current Report on Form 8-K does not purport to update Management’s Discussion and Analysis of Financial Condition and Results of Operations included in the 2013 10-K for any information, uncertainties, transactions, risks, events or trends occurring, or known to management. More current information may be included in, and should be read in conjunction with, the Company’s other filings with the U.S. Securities and Exchange Commission.

ITEM 6. SELECTED FINANCIAL DATA

The consolidated statement of operations data for each of the two years in the period ended December 31, 2013 and the consolidated balance sheet data as of December 31, 2012 and 2013 have been derived from our audited consolidated financial statements appearing elsewhere in this report. The consolidated statement of operations data for the years ended December 31, 2009, 2010 and 2011 and the consolidated balance sheet data as of December 31, 2009, 2010 and 2011 have been derived from our audited consolidated financial statements that do not appear in this report. Luna has not recast the selected financial data for the years ended December 31, 2009, 2010 or 2011, as management has assessed the materiality of recasting these disclosures for such years, both quantitatively and qualitatively, and concluded that recasting these disclosures for such years is not material to any of Luna’s previously issued or current year financial statements. The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and the accompanying notes included in Exhibit 99.3 of this Current Report on Form 8-K and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in Exhibit 99.2 of this Current Report on Form 8-K. The selected data in this section is not intended to replace the consolidated financial statements, and the historical results are not necessarily indicative of the results to be expected in any future period.

In thousands, except share and per share data	2009 (a)	2010	2011	2012	2013
Consolidated Statement of Operations Data:					
Revenues:					
Technology development revenues	\$ 16,160	\$ 14,365	\$ 15,586	\$ 15,127	\$ 11,422
Products and Licensing revenues	9,374	12,133	13,196	8,339	6,912
Total revenues	25,534	26,498	28,782	23,466	18,334
Cost of revenues:					
Technology development costs	11,212	10,454	11,483	10,749	8,882
Products and Licensing costs	4,784	5,787	6,590	3,825	3,403
Total cost of revenues	15,996	16,241	18,073	14,574	12,285
Gross profit	9,538	10,257	10,709	8,892	6,049
Operating expense	29,881	14,425	13,557	13,022	14,084
Operating loss	(20,343)	(4,168)	(2,848)	(4,130)	(8,035)
Other income, net	1	77	228	108	347
Interest expense, net	(504)	(474)	(388)	(312)	(207)
Loss from continuing operations before reorganization items and income tax					
	(20,846)	(4,565)	(3,008)	(4,334)	(7,895)
Reorganization Costs	1,898	174	—	—	—
Loss from continuing operations before income tax	(22,744)	(4,739)	(3,008)	(4,334)	(7,895)
Income tax benefit	(500)	(478)	(479)	(1,107)	(2,387)
Loss from continuing operations, net	(22,244)	(4,261)	(2,529)	(3,227)	(5,508)
Income from discontinued operations, net of income taxes	1,799	1,641	1,137	1,843	4,705
Net loss	(20,445)	(2,620)	(1,392)	(1,384)	(803)
Preferred stock dividend	—	361	127	120	102
Net loss attributable to common stockholders	\$ (20,445)	\$ (2,981)	\$ (1,519)	\$ (1,504)	\$ (905)
Net loss per share from continuing operations:					
Basic	\$ (1.98)	\$ (0.33)	\$ (0.19)	\$ (0.23)	\$ (0.38)
Diluted	\$ (1.98)	\$ (0.33)	\$ (0.19)	\$ (0.23)	\$ (0.38)
Net income per share from discontinued operations:					
Basic	\$ 0.16	\$ 0.13	\$ 0.08	\$ 0.13	\$ 0.33
Diluted	\$ 0.16	\$ 0.13	\$ 0.08	\$ 0.13	\$ 0.33
Net loss per share attributable to common stockholders:					
Basic	\$ (1.82)	\$ (0.23)	\$ (0.11)	\$ (0.11)	\$ (0.06)
Diluted	\$ (1.82)	\$ (0.23)	\$ (0.11)	\$ (0.11)	\$ (0.06)
Weighted-average number of shares used in per share calculations:					
Basic and Diluted	11,232,716	13,009,326	13,647,555	13,930,267	14,336,135

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 5,229	\$ 7,217	\$ 8,939	\$ 6,340	\$ 7,779
Working capital	16,529	8,055	10,928	10,509	10,106
Total assets	21,758	22,876	22,919	20,458	19,704
Total current liabilities	5,556	10,648	8,407	6,932	7,206
Total debt	5,000	6,307	5,250	3,625	2,125

- (a) In April 2009, a jury awarded Hansen Medical Inc. (“Hansen”) a judgment of \$36.3 million following a trial. In January 2010, we and Hansen entered into a settlement agreement that reduced our liability to \$9.7 million. This amount was recognized in operating expenses for the year ended December 31, 2009 and is included in accrued liabilities at December 31, 2009. As a result of the jury award, we performed an interim goodwill and intangible asset impairment analysis. As a result of this analysis, we recognized an impairment of \$1.3 million during the quarter ended March 31, 2009. We also determined that our remaining deferred tax asset was no longer likely to be realized and placed a valuation allowance of \$0.6 million against the asset. On July 17, 2009, we filed a voluntary petition for relief in order to reorganize under Chapter 11 of the United States Bankruptcy Code. As a result of this action, we incurred significant legal expenses that are included in reorganization expenses for the year ended December 31, 2009 in the table above.

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 and the information included elsewhere in this report as well as our Annual Report on Form 10-K, particularly under the head "Risk Factors." 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.

Business Overview

We develop, manufacture and market fiber optic sensing and test & measurement products focused on bringing new and innovative technology solutions to measure, monitor, protect and improve critical processes in the aerospace, automotive, energy, composite, telecommunications, and defense industries. In addition, we provide applied research services, typically under research programs funded by the U.S. government, in areas of advance materials, sensing, and healthcare applications. Our business model is designed to accelerate the process of bringing new and innovative products to market. We use our in-house technical expertise across a range of technologies to perform applied research services for companies and government-funded projects. We continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth.

Our corporate growth strategy is focused on becoming the leading provider of fiber optic strain & temperature sensing solutions and standard test methods for composite, as well as non-composite materials, structures and systems.

We are organized into two main business segments, our Products and Licensing segment and our Technology Development segment. Our Products and Licensing segment develops, manufactures and markets our fiber optic sensing, as well as test and measurement products and also conducts applied research in the fiber optic sensing area for both corporate and government customers. We are continuing to develop and commercialize our fiber optic technology for strain and temperature sensing applications for the aerospace, automotive, and energy industries. Our Products and Licensing segment revenues represented approximately 36% and 38% of our total revenues for the years ended December 31, 2012 and 2013, respectively. A breakdown of our operating income (loss) by segment, as well as our total assets by segment, is provided in footnote 13 to our consolidated financial statements included in this report.

Our Technology Development segment performs applied research principally in the areas of sensing and instrumentation, advanced materials and health sciences. Our Technology Development segment comprised approximately 64% and 62% of our total revenues for the years ended December 31, 2012 and 2013, respectively. Prior to our sale of our Secure Computing and Communications group, or SCC, to MacAulay-Brown, Inc., or Mac-B, SCC provided innovative solutions designed to secure critical technologies within the U.S. government. SCC conducted applied research and provided services to the government in this area, with its revenues primarily derived from U.S. government contracts and purchase orders. Following the sale of SCC, our Technology Development segment predominantly performs applied research in the areas of sensing and materials. Most of the government funding for our Technology Development segment excluding SCC is derived from the Small Business Innovation Research, or SBIR, program coordinated by the U.S. Small Business Administration, or SBA.

We generate revenues through technology development services provided under contractual arrangements, product sales, product development under contractual relationships and license fees. Our Technology Development segment revenues have historically accounted for a large portion 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 segment revenues decreased from \$15.1 million in 2012 to \$11.4 million in 2013. The decrease from 2012 to 2013 was caused primarily by a decrease in our optical systems group due to the completion of certain large contracts during 2012 that were not renewed or replaced in 2013.

Within the Technology Development segment, 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, which is 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, representing firm orders for which funding has not yet been appropriated. Indefinite delivery and quantity contracts and unexercised options are not reported in total backlog. The approximate value of our Technology Development segment backlog was \$8.7 million at December 31, 2013 and \$10.3 million at December 31, 2012, excluding \$3.3 million of backlog related to SCC as of December 31, 2012.

Revenues from product sales currently represent a smaller portion 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. We continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. 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. Over time, however, we do intend to gradually increase such revenues. In the near term, we expect revenues from product sales and product development to be primarily in areas associated with our fiber optic instrumentation, test and measurement and sensing platforms. In the long term, we expect that revenues from product sales will represent a larger portion 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 net losses attributable to common stockholders of approximately \$1.5 million and \$0.9 million for the years ended December 31, 2012 and 2013, respectively.

We expect to continue to incur increasing expenses as we seek to expand our business, including expenses for research and development, sales and marketing and manufacturing capabilities. 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 to incur net losses for the foreseeable future, and these losses could be substantial.

On January 21, 2014, we sold our assets associated with the development of fiber optic shape sensing and localization for the medical field to affiliates of Intuitive, for total cash consideration of up to \$30 million, including \$12 million received in 2014 and up to \$18 million that we may receive in the future based on the achievement of certain technical milestones and royalties on system sales if any. Our revenues recognized related to fiber optic shape sensing in medical applications and SCC were \$8.9 million and \$5.9 million for the years ended December 31, 2012, and 2013, respectively.

Our sales of SCC in 2013 and our medical shape sensing business, in 2014 are expected to result in lower revenues until we can increase revenues significantly, primarily from product sales. As a result, we may incur greater net losses than we have in prior years.

Description of Our Revenues, Costs and Expenses

Revenues

We generate revenues from technology development, product sales and commercial product development and licensing activities. 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 technology development revenues represented approximately 64% and 62% of our total revenues for the years ended December 31, 2012 and 2013, respectively.

Our products and licensing revenues reflect amounts that we receive from sales of our products or development of products for third parties, as well as fees paid to us in connection with licenses or sub-licenses of certain patents and other intellectual property, and represented approximately 36% and 38% of our total revenues for the years ended December 31, 2012 and 2013, respectively.

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 warranties; and inventory obsolescence, as well as overhead allocated to each of these activities.

Operating Expense

Operating expense consists of selling, general and administrative expenses, as well as expenses related to research, development and engineering, 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 segment; product development activities not provided under contracts with third parties; and overhead costs related to these activities.

Interest Expense, net

In February 2010, we entered into a new line of credit facility with Silicon Valley Bank, or SVB, with a borrowing capacity of \$5.0 million. In May 2011, we entered into a loan modification agreement with SVB under which we repaid the outstanding balance under the prior line of credit and obtained a term loan in the amount of \$6.0 million, along with a new \$1.0 million line of credit. In May 2012, we entered into another loan modification agreement with SVB under which we extended the maturity date of the line of credit to May 2014 and adjusted certain covenants. On March 21, 2013, we entered into another loan modification agreement with SVB under which we replaced the previous financial covenants with a single covenant that we maintain a minimum cash balance of \$5.0 million. At December 31, 2013, we had \$2.1 million outstanding on the term loan and no amounts outstanding on the line of credit. Effective on January 21, 2014, this minimum cash balance covenant was modified to reduce the required minimum balance to \$3.5 million.

During the years 2012 and 2013, interest expense included interest accrued on our outstanding bank credit facilities, and interest incurred with respect to our capital lease obligations.

Interest income includes amounts earned on our cash deposits with financial institutions.

Critical Accounting Policies and Estimates

Technology Development Revenues

We perform research and development for U.S. Federal government agencies, educational institutions and commercial organizations. We recognize revenue under research contracts when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred, and collectability of the contract price is considered reasonably assured 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 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. Revenue from cost reimbursable contracts is 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 from time and materials contracts is recognized based on direct labor hours expended at contract billing rates plus 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 proportional 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 as this method more accurately measures performance under these arrangements. For fixed price contracts that provide for the development and delivery of a specific prototype or product, revenue is recognized based upon the percentage of completion method.

Our contracts with agencies of the U.S. 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 collectability 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 reasonably assured.

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, and data that are 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, and 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 likely have a significant impact on revenues recognized for those contracts.

Products and Licensing Revenues

We recognize revenue relating to our product sales 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. For tangible products that contain software that is essential to the tangible product's functionality, we consider the product and software to be a single unit of accounting and recognize revenue accordingly. We evaluate product sales that are a part of multiple-element revenue arrangements to determine whether separate units of accounting exist, and we follow appropriate revenue recognition policies for each separate unit. For multi-element arrangements we allocate revenue to all significant deliverables based on their relative selling prices. In such circumstances, we use a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) vendor-specific objective evidence of fair value, or VSOE, (ii) third-party evidence of selling price or TPE, and (iii) best estimate of the selling price, or ESP. VSOE generally exists only when we sell the deliverable separately and is the price actually charged by us for that deliverable. Our product sales often include bundled products, options and services and therefore VSOE is not readily determinable. In addition, we believe that because of unique features of our products, TPE also is not available. ESPs reflect our best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis.

Our process for determining ESP for deliverables without VSOE or TPE considers multiple factors that may vary depending upon the unique facts and circumstances related to each deliverable. Key factors considered in developing the ESPs include prices charged by us for similar offerings, our historical pricing practices, the nature of the deliverables, and the relative ESP of all of the deliverables as compared to the total selling price of the product. We may also consider, when appropriate, the impact of other products and services, on selling price assumptions when developing and reviewing our ESPs.

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 differences, 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.

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. While it is often difficult to predict the final outcome of 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 accrued liabilities in our consolidated balance sheets. We adjust this 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 and 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 those 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.

Stock-Based Compensation

We recognize stock-based compensation expense based upon the fair value of the underlying equity award on the date of the grant. We have 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 basis 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, we use the lifetime volatility of our common stock.

Long-lived and Intangible Assets

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future un-discounted 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 asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less cost to sell.

Results of Operations

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

	<u>Year ended December 31,</u>	
	<u>2012</u>	<u>2013</u>
Revenues:		
Technology development revenues	64.5%	62.3%
Product and licensing revenues	35.5	37.7
Total revenues	100.0	100.0
Cost of Revenues:		
Technology development costs	45.8	48.4
Product and licensing costs	16.3	18.6
Total cost of revenues	62.1	67.0
Gross Profit	37.9	33.0
Operating Expense	55.5	76.8
Operating Loss	(17.6)	(43.8)
Total Other (Expense) Income, net	(0.9)	0.8
Loss from continuing operations before income taxes	(18.5)	(43.1)
Loss from continuing operations	(13.8)	(30.1)
Income from discontinued operations, net of income taxes	7.9	25.7
Net Loss	(5.9)	(4.4)

Year Ended December 31, 2013 Compared to Year Ended December 31, 2012

Revenues

	<u>2013</u>	<u>2012</u>	<u>\$ Difference</u>	<u>% Difference</u>
Technology development revenues	\$11,421,868	\$15,126,834	\$(3,704,966)	(24.5)%
Products and licensing revenues	6,911,707	8,338,967	(1,427,260)	(17.1)%
Total revenues	\$18,333,575	\$23,465,801	\$(5,132,226)	(21.9)%

Our Technology Development segment revenue decreased \$3.7 million from \$15.1 million in the year ended December 31, 2012 to \$11.4 million in the year ended December 31, 2013. This decrease was due primarily to a decline in revenues from our optical systems group of \$3.2 million due to the completion of certain large contracts during the second half of 2012, which contracts were not renewed or replaced in 2013.

Our Products and Licensing segment revenue decreased from \$8.3 million to \$6.9 million, a decrease of 17.1%, for the year ended December 31, 2013 as compared to the year ended December 31, 2012. Our Products and Licensing segment revenues decreased primarily due to softness in the telecom test and measurement industry overall, which resulted in \$0.9 million decline in sales of our OVA products and a \$0.2 million decline in sales of our Phoenix laser products.

Cost of Revenues

	<u>2013</u>	<u>2012</u>	<u>\$ Difference</u>	<u>% Difference</u>
Technology development costs	\$ 8,882,071	\$10,749,335	\$(1,867,264)	(17.4)%
Products and licensing costs	3,402,846	3,824,661	(421,815)	(11.0)%
Total costs of revenues	\$12,284,917	\$14,573,996	\$(2,289,079)	(15.7)%

Our Technology Development segment costs decreased to \$8.9 million for the year ended December 31, 2013 from \$10.7 million for the year ended December 31, 2012 a decrease of 17.4%. The decrease primarily reflects a \$2.0 million decrease in costs, including direct labor, overhead, and subcontractor charges, associated with reduced contract work in our optical systems group for 2013 compared to 2012.

Our Products and Licensing segment costs decreased to \$3.4 for the year ended December 31, 2013 from \$3.8 million for the year ended December 31, 2012 a decrease of 11.0%. The decrease was caused primarily by the decline in products sales described above. Product revenue declined 17.1% for the same period. Costs of sales were 49% for the year ended December 31, 2013 compared to 48% for the year ended December 31, 2012.

Operating Expense

	2013	2012	\$ Difference	% Difference
Selling general and administrative expense	\$10,970,775	\$10,249,444	\$ 721,331	7.0%
Research, development, and engineering expense	3,113,193	2,772,438	340,755	12.3%
Total operating expense	\$14,083,968	\$13,021,882	\$1,062,086	8.2%

Selling, general and administrative expenses increased by \$0.7 million, or 7.0%, to \$11.0 million for the year ended December 31, 2013, as compared to \$10.2 million for the year ended December 31, 2012. This increase was due to costs recognized of \$0.8 million in 2013 in connection with the sale of our shape sensing business in the medical field to Intuitive, which transaction was closed in January 2014.

Research, development, and engineering expenses increased \$0.3 million, or 12.3%, from \$2.8 million for 2012 to \$3.1 million for 2013. This increase is primarily due to increased engineering expenses in our products and licensing segment as resources were more heavily directed toward internal development programs, including development of our ODISI B product, rather than third-party funded product development activities.

Interest Expense and Other Income

Our net interest expense was approximately \$208,000 for the year ended December 31, 2013 compared to approximately \$312,000 for the year ended December 31, 2012. During 2012 and 2013, our primary outstanding borrowing was the term loan provided by SVB. The average monthly loan balance for the year ended December 31, 2013 was \$2.9 million as compared to \$4.4 million for the year ended December 31, 2012, resulting in a decrease in interest expense.

Other income was approximately \$347,000 for the year ended December 31, 2013 and \$108,000 for the year ended December 31, 2012. During the year ended December 31, 2013, we received approximately \$48,000 from an insurance policy profit share and \$265,000 in rent income from a sublease of office space. We also recognized additional income from the amortization of the discount we received on prepayment of the Hansen Note of approximately \$38,000, which was fully amortized during the second quarter of 2013. Other income for 2012 was primarily due to the full year amortization of the Hansen Note of approximately \$93,000.

Income Tax Benefit

We recognized alternative minimum income taxes in the amounts of \$14,071 and \$21,417 for the years ended December 31, 2013 and 2012, respectively. For the year ended December 31, 2013, we recognized in continuing operations an income tax benefit of \$2,387,422, which is offset by the tax expense recognized on the gain on sale of the SCC business and the operating results of our shape sensing business included in discontinued operations. For the year ended December 31, 2012, we recognized in continuing operations an income tax benefit of \$1,106,564, which is offset by the tax expense recognized on the results of operations of the SCC business and the shape sensing business included in the discontinued operations.

Loss from Continuing Operations

As a result of the foregoing, including our \$5.1 million decline in revenues and \$1.3 million increase in operating expenses during the year ended December 31, 2013, compared to the prior year, offset by an increase of \$1.2 million in income tax benefit we incurred a net loss from continuing operations of approximately \$5.5 million, as compared to a net loss from continuing operations of \$3.3 million for the year ended December 31, 2012.

Income from Discontinued Operations

For the year ended December 31, 2013, we recognized net income from discontinued operations of \$4.7 million, compared to net income from discontinued operations of \$1.8 million for the year ended December 31, 2012. For 2013, this income consisted of a \$3.4 million gain realized on the sale of SCC, net of income taxes, which occurred during the first quarter of 2013, and an operating income of \$1.3 million related to the operations of our medical shape sensing business and SCC prior to the sale of SCC in the first quarter of 2013, net of \$0.9 million income taxes. For 2012, this income consisted of the operations of SCC and our medical shape sensing business of \$1.8 million in the aggregate, net of \$1.1 million income tax.

Preferred Stock Dividend

In January 2010, we issued 1,321,514 shares of our newly designated Series A Convertible Preferred Stock to Carilion. The Series A Convertible Preferred Stock carries an annual cumulative dividend of 6%, or approximately \$0.2815 per share. During 2013 and 2012, we accrued approximately \$102,000 and \$120,000, respectively, for the dividends payable to Carilion. The dividends are not payable in cash, but rather in shares of our Common Stock, until liquidation event occurs. During each of 2013 and 2012, 79,292 shares of common stock became issuable to Carilion as dividends and have been recorded in the statement of stockholders' equity.

Liquidity and Capital Resources

At December 31, 2013, our total cash and cash equivalents were approximately \$7.8 million. The sale of SCC on March 1, 2013 significantly increased our cash and cash equivalents by providing us with net proceeds of approximately \$5.2 million, after deducting transaction expenses paid by us. Included in the \$5.2 million is \$125,000, which was placed in escrow to be released in tranches over 18 months after closing, subject to certain events and dates and to any indemnification claims of Mac-B.

On May 18, 2011, we entered into an agreement with SVB under which SVB made a term loan to us in the amount of \$6.0 million. The term loan is to be repaid by us in 48 monthly installments, plus accrued interest payable monthly in arrears, and, unless earlier terminated, matures on the earlier of either May 1, 2015 or an event of a default under the underlying loan and security agreement. The term loan carries a floating annual interest rate equal to SVB's prime rate then in effect plus 2%.

We may prepay amounts due under the term loan at any time with no penalties.

In addition to the terms and conditions of the term loan, we have a revolving credit facility with SVB with a maximum borrowing capacity of \$1.0 million and a maturity date of May 18, 2014.

The annual interest rate on the revolving facility is equal to SVB's prime rate plus 1.25%, payable monthly in arrears, with an unused line of credit fee one-quarter of one percent (0.25%), payable monthly. We may terminate the line of credit for a termination fee of \$10,000, which fee would not be payable in the event that the line of credit is replaced by another loan facility with SVB.

Amounts due under the term loan and the revolving line of credit, which we refer to together as the Credit Facilities, are secured by substantially all of our assets, including intellectual property, personal property and bank accounts.

On March 21, 2013, the Credit Facilities were amended to replace the existing financial covenants with a single covenant that we maintain a minimum cash balance of \$5.0 million. Effective on January 21, 2014, in connection with our sale of assets to Intuitive, this covenant was modified to reduce the minimum cash balance to \$3.5 million. We are in compliance with all covenants under the Credit Facilities.

The Credit Facilities contain customary events of default, including nonpayment of principal, interest or other amounts, violation of covenants, material adverse change, an event of default under any subordinated debt documents, incorrectness of representations and warranties in any material respect, bankruptcy, judgments in excess of a threshold amount, and violations of other agreements in excess of a threshold amount. If any event of default occurs SVB may declare due immediately all borrowings under the Credit Facilities and foreclose on the collateral. Furthermore, an event of default under the Credit Facilities would result in an increase in the interest rate on any amounts outstanding.

The balance under the term loan at December 31, 2013 was \$2,125,000, of which \$625,000 was classified as long-term and \$1,500,000 was classified as short-term. No amounts were outstanding under the line of credit at December 31, 2013.

In January 2014, we completed a sale of certain assets to Intuitive. Under the terms of the sale agreement we have received \$12.0 million.

We believe that our current cash balance, together with our cash flow from operations, the expected payments from Intuitive in 2014 and the funds available to us under the Credit Facilities with SVB, will provide adequate liquidity for us to meet our working capital needs during the remainder of 2014.

Discussion of Cash Flows

	<u>Twelve months ended</u>	
	<u>2012</u>	<u>2013</u>
Net cash provided by/(used in) operating activities	\$ (396,768)	\$(1,787,292)
Net cash (used in)/provided by investing activities	(595,927)	4,670,448
Net cash used in by financing activities	<u>(1,605,971)</u>	<u>(1,445,076)</u>
Net (decrease)/increase in cash	\$(2,598,666)	\$ 1,438,080

During 2013, operations used \$1.8 million of net cash, as compared to 2012, when operations used \$0.4 million of net cash. In 2013, our net loss of \$0.8 million included a benefit of an after-tax gain on the sale of SCC of \$3.3 million and a tax benefit of \$1.5 million. Absent the effects of that gain and the tax benefit, our pre-tax loss from continuing operations was \$5.5 million. The pre-tax loss from continuing operations included charges for depreciation and amortization of \$0.9 million, share-based compensation of \$1.2 million and allowance for doubtful accounts of \$0.1 million all of which are non-cash items that do not impact cash flow for the period. Additionally, changes in working capital provided net cash inflow of \$1.7 million, principally due to a decrease of \$1.5 million in accounts receivable.

In 2012, our net loss of \$1.4 million and \$2.0 million in net cash outflows from changes in operating assets and liabilities was partially offset by \$3.0 million in non-cash expenses.

Cash used in or provided by investing activities relates to the purchase of property and equipment as well as capitalized costs associated with securing intellectual property rights and, in 2013, the sale of SCC. Our overall cash provided by investing activities was \$4.7 million in 2013, consisting of a cash inflow \$5.1 million from the sale of SCC in March of 2013 and the cash outflow of \$0.2 million for the purchase of equipment, compared to \$0.4 million for 2012 and we incurred \$0.3 million in patent costs associated with certain intangible assets, primarily associated with our fiber optic platform, compared to \$0.2 million 2012.

Cash used in financing activities for the year ended December 31, 2013 was \$1.4 million compared to cash used in financing activities of \$1.6 million in 2012.

During 2013, we repaid \$1.5 million to SVB for principal on our Term Loan. We also paid approximately \$57,000 for leased equipment and received approximately \$112,000 from the exercise of options and warrants.

During 2012, we repaid \$1.6 million to SVB for principal on our Term Loan. We also paid approximately \$50,000 for leased equipment and received approximately \$70,000 from the exercise of options and warrants.

Summary of Contractual Obligations

The following table sets forth information concerning our known contractual obligations as of December 31, 2013 that are fixed and determinable.

	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Long-term debt obligations (1)	\$2,125,000	\$1,500,000	\$ 625,000	\$ —	\$ —
Operating facility leases (2)	2,434,894	1,014,131	1,109,023	311,740	—
Other leases (3)	176,924	66,617	102,601	7,706	—
Purchase order obligation (4)	1,405,026	1,180,682	224,344	—	—
City of Danville grant (5)	21,593	21,593	—	—	—
Other liabilities (6)	1,830,000	320,000	850,000	440,000	220,000
Total	\$7,993,437	\$4,103,023	\$2,910,968	\$759,446	\$ 220,000

- (1) Amounts due under our debt obligations to SVB are payable in monthly installments through May 2015.
- (2) We lease our facilities in Blacksburg, Charlottesville and Roanoke, Virginia under operating leases that as of December 31, 2013, were scheduled to expire between November 2014 and December 2018. On March 21, 2013, we amended the lease on our Roanoke office to reduce the square footage covered by the lease effective as of May 1, 2014 and extend the term of the lease through December 2018. Upon expiration of the leases, we may exercise certain renewal options as specified in the leases.
- (3) In February 2011 and August 2013 we executed \$274,000 and \$50,100 leases, respectively, for equipment for our offices in Roanoke, Blacksburg and Charlottesville, Virginia. These equipment leases expire in February 2016 and August 2018, respectively.
- (4) In the fourth quarter of 2013 our Luna Technologies subsidiary executed two non-cancelable purchase orders in the amounts of \$0.9 million and \$0.5 million for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in December of 2013. The amount set forth in the table above represents our remaining obligation as of December 31, 2013.
- (5) In March 2004, we received a \$900,000 grant from the City of Danville, Virginia. One-half of the grant was to be used to offset certain capital expenditures for leasehold improvements being made at our Danville facility, and one-half was to be used for our creation of new jobs. We satisfied the job creation criteria in full and the capital expenditures criteria in part in 2008 and recognized \$668,000 of the grant as income for that year. In 2009 and 2010 we satisfied additional criteria and earned another approximately \$124,000 of the grant. In January 2010, we agreed to repay the remaining \$108,000 of the grant in quarterly installments through November 2014.
- (6) Other liabilities include remaining amounts payable for minimum royalty payments for certain licensed technologies payable over the remaining patent terms of the underlying technology.

Off-Balance Sheet Arrangements

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

Inflation

We do not believe that inflation has had a material effect on our business, financial condition or results of operations.

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 (the "Company") as of December 31, 2012 and 2013, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the two years in the period ended December 31, 2013. Our audits of the basic consolidated financial statements included the financial statement schedule included as an exhibit on Form 8-K (File No. 000-52008). 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 consolidated financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's 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, 2012 and 2013, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2013, 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 consolidated statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

McLean, Virginia
April 10, 2014 (except for Note 15, as to which the date is February 9, 2015)

CONSOLIDATED BALANCE SHEETS

	December 31, 2012	December 31, 2013
Assets		
Current assets;		
Cash and cash equivalents	\$ 6,340,461	\$ 7,778,541
Accounts receivable, net	7,059,635	5,408,281
Inventory, net	3,336,916	3,346,177
Prepaid expenses	667,773	708,974
Other current assets	35,629	70,208
Total current assets	17,440,414	17,312,181
Property and equipment, net	2,426,638	2,060,709
Intangible assets, net	437,839	288,475
Other assets	152,877	42,710
Total assets	<u>\$ 20,457,768</u>	<u>\$ 19,704,075</u>
Liabilities and stockholders' equity		
Current Liabilities;		
Current portion of long term debt obligation	1,500,000	1,500,000
Current portion of capital lease obligation	54,091	66,617
Accounts payable	1,797,571	1,401,764
Accrued compensation	1,648,064	2,205,612
Accrued liabilities	863,214	1,219,650
Accrued liabilities - other	235,897	121,323
Deferred credits	832,822	691,424
Total current liabilities	6,931,659	7,206,390
Long-term debt obligation	2,125,000	625,000
Long-term capital lease obligation	128,917	110,307
Total liabilities	<u>9,185,576</u>	<u>7,941,697</u>
Commitments and contingencies		
Stockholders' equity;		
Preferred stock, par value \$0.001, 1,321,514 shares authorized, issued and outstanding at December 31, 2012 and 2013, respectively	1,322	1,322
Common stock, par value \$0.001, 100,000,000 shares authorized, 14,009,280 and 14,527,335 shares issued and outstanding at December 31, 2012 and 2013, respectively	14,245	14,842
Additional paid-in capital	61,361,505	62,756,571
Accumulated deficit	(50,104,880)	(51,010,357)
Total stockholders' equity	<u>11,272,192</u>	<u>11,762,378</u>
Total liabilities and stockholders' equity	<u>20,457,768</u>	<u>19,704,075</u>

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

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years ended December 31,	
	2012	2013
Revenues:		
Technology development revenues	\$15,126,834	\$11,421,868
Products and licensing revenues	8,338,967	6,911,707
Total revenues	<u>23,465,801</u>	<u>18,333,575</u>
Cost of revenues:		
Technology development costs	10,749,335	8,882,071
Products and licensing costs	3,824,661	3,402,846
Total cost of revenues	<u>14,573,996</u>	<u>12,284,917</u>
Gross profit	<u>8,891,805</u>	<u>6,048,658</u>
Operating expense:		
Selling, general & administrative	10,249,444	10,970,775
Research, development, and engineering	2,772,438	3,113,193
Total operating expense	<u>13,021,882</u>	<u>14,083,968</u>
Operating loss	<u>(4,130,077)</u>	<u>(8,035,310)</u>
Other income (expense):		
Other income, net	108,061	347,026
Interest expense, net	(312,372)	(207,538)
Total other (expense) income	<u>(204,311)</u>	<u>139,488</u>
Loss from continuing operations before income taxes	<u>(4,334,388)</u>	<u>(7,895,822)</u>
Income tax benefit	(1,106,564)	(2,387,422)
Loss from continuing operations, net	<u>(3,227,824)</u>	<u>(5,508,400)</u>
Income from discontinued operations, net of income taxes (\$1.1 million and \$2.4 million, respectively)	<u>1,843,439</u>	<u>4,705,250</u>
Net loss	<u>(1,384,385)</u>	<u>(803,150)</u>
Preferred stock dividend	119,754	102,327
Net loss attributable to common stockholders	<u>\$ (1,504,139)</u>	<u>\$ (905,477)</u>
Net loss per share from continuing operations:		
Basic	\$ (0.23)	\$ (0.38)
Diluted	\$ (0.23)	\$ (0.38)
Net income per share from discontinued operations:		
Basic	\$ 0.13	\$ 0.33
Diluted	\$ 0.13	\$ 0.33
Net loss per share attributable to common stockholders:		
Basic	\$ (0.11)	\$ (0.06)
Diluted	\$ (0.11)	\$ (0.06)
Weighted average shares:		
Basic and diluted	13,930,267	14,336,135

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

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional Paid in Capital</u>	<u>Accumulated Deficit</u>	<u>Total</u>
	<u>Shares</u>	<u>\$</u>	<u>Shares</u>	<u>\$</u>			
Balance—January 1, 2012	1,321,514	1,322	13,812,490	13,969	59,289,516	(48,600,741)	10,704,066
Exercise of stock options and warrants	—	—	182,702	183	69,795	—	69,978
Stock-based compensation	—	—	—	—	1,862,533	—	1,862,533
Stock dividends (1)	—	—	—	79	119,675	(119,754)	—
Issuance of Common Stock, Other (2)	—	—	14,088	14	19,986	—	20,000
Net loss	—	—	—	—	—	(1,384,385)	(1,384,385)
Balance—December 31, 2012	1,321,514	1,322	14,009,280	14,245	61,361,505	(50,104,880)	11,272,192
Exercise of stock options and warrants	—	—	169,277	168	111,789	—	111,957
Stock-based compensation	—	—	337,500	338	1,166,041	—	1,166,379
Stock dividends (1)	—	—	—	80	102,247	(102,327)	—
Issuance of Common Stock, Other (2)	—	—	11,278	11	14,989	—	15,000
Net loss	—	—	—	—	—	(803,150)	(803,150)
Balance—December 31, 2013	<u>1,321,514</u>	<u>\$1,322</u>	<u>14,527,335</u>	<u>\$14,842</u>	<u>\$62,756,571</u>	<u>\$(51,010,357)</u>	<u>\$11,762,378</u>

- (1) The stock dividends payable in connection with the Series A Convertible Preferred Stock are issuable upon the request of Carilion.
(2) Fees paid to our board of directors by issuance of our common stock.

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	<u>2012</u>	<u>2013</u>
Cash flows used in operating activities:		
Net loss	\$(1,384,385)	\$ (803,150)
Adjustments to reconcile net loss to net cash provided/(used in) by operating activities:		
Depreciation and amortization	1,092,027	935,477
Stock-based compensation	1,882,533	1,181,379
Gain on sale of discontinued operations, net of income taxes	—	(3,391,451)
Allowance for doubtful accounts or bad debt expense	—	134,811
Tax benefit from utilization of loss from current year operations	—	(1,507,791)
Changes in operating assets and liabilities:		
Accounts receivable	(1,101,549)	1,533,827
Inventory	(10,482)	(9,261)
Other assets	478,919	(79,180)
Accounts payable and accrued expenses	(724,050)	396,352
Deferred credits	(629,781)	(178,305)
Net cash used in operating activities	<u>(396,768)</u>	<u>(1,787,292)</u>
Cash flows (used in)/provided by investing activities:		
Acquisition of property and equipment	(371,390)	(186,956)
Intangible property costs	(224,537)	(253,451)
Proceeds from sale of discontinued operations, net of fees	—	5,110,855
Net cash (used in)/provided by investing activities	<u>(595,927)</u>	<u>4,670,448</u>
Cash flows provided by/(used in) financing activities:		
Payments on debt obligations	(1,625,000)	(1,500,000)
Payments on capital lease obligation	(50,949)	(57,033)
Proceeds from the exercise of options and warrants	69,978	111,957
Net cash used in financing activities	<u>(1,605,971)</u>	<u>(1,445,076)</u>
Net change in cash	<u>(2,598,666)</u>	<u>1,438,080</u>
Cash and cash equivalents—beginning of period	8,939,127	6,340,461
Cash and cash equivalents—end of period	<u>\$ 6,340,461</u>	<u>\$ 7,778,541</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 297,875	\$ 178,646
Dividend on preferred stock, 79,292 shares of common stock issuable at each of December 31, 2012 and 2013	\$ 119,754	\$ 102,327
Cash paid for income taxes	\$ 21,618	\$ 14,010

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Luna Innovations Incorporated (“We” or the “Company”), headquartered in Roanoke, Virginia was incorporated in the Commonwealth of Virginia in 1990 and reincorporated in the State of Delaware in April 2003.

We develop, manufacture and market fiber optic sensing and test & measurement products focused on bringing new and innovative technology solutions to measure, monitor, protect and improve critical processes in the aerospace, automotive, energy, composite, telecommunications and defense industries. Our business model is designed to accelerate the process of bringing new and innovative products to market. We use our in-house technical expertise to perform applied research services on government-funded projects across a range of technologies and also for corporate customers in the fiber optic sensing area. We are organized into two business segments: our Technology Development segment and our Products and Licensing segment. Our Technology Development segment performs applied research principally on government-funded projects. Most of the government funding in our Technology Development segment is derived from the U.S. Government’s Small Business Innovation Research, or SBIR, program coordinated by the U.S. Small Business Administration, or SBA. Our Products and Licensing segment focuses on fiber optic test and measurement, sensing, and instrumentation products.

We have a history of net losses and negative cash flow from operations. We have historically managed our liquidity through cost reduction initiatives, debt financings and capital markets transactions.

Although there can be no guarantees, we believe that our current cash balance, including the proceeds from the sale of our medical shape sensing business to Intuitive in January 2014 described in Note 15, our cash flow from operations, and the funds available to us under the Credit Facility described in Note 3 below, provide adequate liquidity for us to meet our working capital needs through 2014.

Discontinued Operations

The Company’s Board of Directors and management determined that it would be in the best interest of the Company’s stockholders to sell the Secure Computing and Communication (“SCC”) group, which was part of the Technology Development segment, and medical shape sensing shape sensing business, which was part of the Product and Licensing Segment. On March 1, 2013, we completed the sale of our SCC for approximately \$6.1 million. On January 21, 2014 we sold our assets associated with the medical shape sensing business for approximately \$30.0 million.

As a result, the Company has classified the operating results, net of taxes, of the aforementioned businesses as discontinued operations. The accompanying consolidated balance sheets of the Company as of December 31, 2012 and 2013, and the related consolidated statements of operations and cash flows for each of the two years in the period ended December 31, 2013, and the related notes to the consolidated financial statements have been retrospectively revised to reflect the classification of discontinued operations for these businesses. See Note 15, Discontinued Operations for further information. Unless otherwise noted, the following notes refer to the Company’s continuing operations.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, or GAAP and include the accounts of the Company and its wholly owned subsidiaries. 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.

Preferred Stock Issued to Carilion Clinic

In January 2010, we entered into a transaction with Carilion Clinic (“Carilion”), in which Carilion agreed to exchange all of its Senior Convertible Promissory Notes in the principal amount of \$5.0 million plus all accrued but unpaid interest, totaling \$1.2 million, for (i) 1,321,514 shares of our newly designated Series A Convertible Preferred Stock and (ii) an additional warrant to purchase 356,000 shares of our common stock at an exercise price of \$2.50 per share. This warrant is exercisable until December 31, 2020. We also agreed to reduce the exercise price of Carilion’s prior common stock warrant from \$7.98 to \$2.50 per share and to extend its expiration date to December 31, 2020. The Series A Convertible Preferred Stock carries a dividend of 6% payable in shares of common stock and maintains a liquidation preference up to \$6.2 million. As of December 31, 2013, a cumulative total of 314,525 shares of common stock were issuable to Carilion, on their demand, as dividends and have been recorded in the statement of stockholders’ equity. Each share of Series A Convertible Preferred Stock may be converted into one share of our common stock at the option of the holder. We recorded the fair value of the Series A Convertible Preferred Stock, determined based upon the conversion value immediately prior to the exchange, the fair value of the new warrant issued, determined using the Black-Scholes valuation model, and the incremental fair value of the prior warrant due to the re-pricing and extension of expiration to stockholders’ equity.

Use of Estimates

The preparation of our consolidated financial statements in accordance with 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. 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 reasonably assured. 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 costs that are determined to be reasonable, allowable and allocable to the contract and are paid a fixed fee representing the profit negotiated between us and the contracting agency. Revenue from cost reimbursable contracts is recognized as costs are incurred plus a portion of the fee earned. Revenue from time and materials contracts is recognized based on direct labor hours expended at contract billing rates plus other billable direct costs.

Revenue from fixed price research contracts that involve the delivery of services and a prototype model is 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 reasonably assured. 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 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.

For multi-element arrangements that include tangible products that contain software that is essential to the tangible product's functionality, we allocate revenue to all deliverables based on their relative selling prices. Other deliverables include extended warranty, training and various add-on products. In such circumstances, we use a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) vendor-specific objective evidence of fair value or VSOE, (ii) third-party evidence of selling price or TPE, and (iii) best estimate of the selling price or ESP. VSOE generally exists only when we sell the deliverable separately and is the price actually charged by us for that deliverable. ESPs reflect our best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis.

Our process for determining our ESP for deliverables without VSOE or TPE considers multiple factors that may vary depending upon the unique facts and circumstances related to each deliverable. Key factors considered in developing the ESPs include prices charged by us for similar offerings, our historical pricing practices, the nature of the deliverables, and the relative

ESP of all of the deliverables as compared to the total selling price of the product. We may also consider, when appropriate, the impact of other products and services on selling price assumptions when developing and reviewing our ESPs.

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 in which 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. The allowance was \$0 at December 31, 2012 and approximately \$134,811 at December 31, 2013.

Cash Equivalents

We consider all highly liquid investments purchased with maturities of three months or less to be cash equivalents. To date, we have not incurred losses related to cash and cash equivalents. The Company regularly maintains cash balances with financial institutions which exceed Federal Deposit Insurance Corporation ("FDIC") insurance limits. At December 31, 2013 and December 31, 2012, the Company had approximately \$7.5 million and \$6.1 million, respectively, in excess of FDIC insured limits.

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.
- 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, accounts receivable 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 comparable to the interest rate on our credit facility with Silicon Valley Bank, which we consider to be at market.

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

Intangible Assets

Intangible assets consist of patents related to certain intellectual property that we have developed or acquired. 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.

Research, Development and Engineering

Research, development and engineering expenses not related to contract performance are expensed as incurred. We expensed \$2.8 million and \$3.1 million of non-contract related research, development and engineering expenses for the years ended December 31, 2012 and 2013, respectively.

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, work in process 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.

Net Loss per Share

Basic per share data is computed by dividing net loss attributable to common stockholders by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing net loss attributable 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 2.4 million and 2.3 million common stock equivalents (which include outstanding warrants and stock options) are not included for the years ended December 31, 2012 and 2013 respectively, as they are antidilutive to earnings per share due to the Company's loss from continuing operations.

Stock-Based Compensation

We have a stock-based compensation plan, which is described further in Note 8. 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 requisite 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:

	2012	2013
Risk-free interest rate range	1.02% – 1.49%	1.27% – 2.34%
Expected life of option-years	7.5	7.5
Expected stock price volatility	108%	108%
Executive turnover rates	— %	— %
Non-executive turnover rates	18.5%	14.7%
Expected dividend yield	—	—

The risk-free interest rate is based on U.S. Treasury interest rates, the terms of which are consistent with the expected life of the stock options. 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, executives and non-executes, within our company. We do not currently issue dividends nor do we expect to in the foreseeable future.

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 tax 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.

2. Inventory

Inventory consists of finished goods, work-in-process 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.

Components of inventory are as follows:

	December 31, 2012	December 31, 2013
Finished goods	\$ 195,578	\$ 719,574
Work-in-process	252,227	361,754
Parts	<u>2,975,297</u>	<u>2,339,595</u>
	3,423,102	3,420,923
Less: Inventory reserves	<u>86,186</u>	<u>74,746</u>
Total inventory, net	<u>\$ 3,336,916</u>	<u>\$ 3,346,177</u>

3. Debt

Silicon Valley Bank Facility

We currently have a Loan and Security Agreement with Silicon Valley Bank (“SVB”) under which we have a term loan with an original borrowing amount of \$6.0 million (the “Term Loan”). The Term Loan is to be repaid by us in 48 monthly installments, plus accrued interest payable monthly in arrears, and unless earlier terminated, matures on the earlier of either May 1, 2015 or an event of a default under the loan agreement. The term loan carries a floating annual interest rate equal to SVB’s prime rate then in effect plus 2%. We may repay amounts due under the Term Loan at any time with no penalties.

In addition to the terms and conditions of the Term Loan, we also have a revolving credit facility (the “Line of Credit” and together with the Term Loan, the “Credit Facilities”) with a maximum borrowing capacity of \$1.0 million. The interest rate on the Line of Credit is SVB’s prime rate plus 1.25%, payable monthly in arrears, and we are required to pay an unused Line of Credit fee of one-quarter of one percent (0.25%), payable monthly. We may terminate the Line of Credit for a termination fee of \$10,000, which fee would not be payable in the event that the Line of Credit is replaced by another loan facility with SVB. The Line of Credit has a maturity date of May 18, 2014.

Amounts due under the Credit Facilities are secured by substantially all of our assets, including intellectual property, personal property and bank accounts.

On March 21, 2013, we entered into a Fourth Loan Modification Agreement with SVB that replaced the existing financial covenants with a single covenant that we maintain a minimum cash balance of \$5.0 million with SVB. Effective on January 21, 2014, in connection with our sale of assets to Intuitive, this covenant was modified to reduce the required minimum cash balance to \$3.5 million. The Credit Facilities also require us to observe a number of operational covenants, including protection and registration of intellectual property rights, and certain customary negative covenants. As of December 31, 2013, we were in compliance with all covenants under the Credit Facilities.

In addition, the Credit Facilities contain customary events of default, including nonpayment of principal, interest or other amounts, violation of covenants, material adverse change, an event of default under any subordinated debt documents, incorrectness of representations and warranties in any material respect, bankruptcy, judgments in excess of a threshold amount, and violations of other agreements in excess of a threshold amount. If any event of default occurs SVB may declare due immediately all borrowings under the Credit Facilities and foreclose on the collateral. Furthermore, an event of default under the Credit Facilities would result in an increase in the interest rate on any amounts outstanding. As of December 31, 2013, there were no events of default on our Credit Facilities.

The balance under the Term Loan at December 31, 2013 was \$2.1 million of which \$0.6 million was classified as long-term and \$1.5 million was classified as short-term. No amounts were outstanding under the Line of Credit and the available credit capacity was \$1.0 million at December 31, 2013. The effective rate of our Term Loan at December 31, 2013 was 6%.

The following table presents a summary of debt outstanding as of December 31, 2012 and 2013:

	December 31,	
	2012	2013
Silicon Valley Bank Term Loan	<u>\$3,625,000</u>	<u>\$2,125,000</u>
Less: current portion	<u>1,500,000</u>	<u>1,500,000</u>
Total long-term debt	<u>\$2,125,000</u>	<u>\$ 625,000</u>

Maturities on long-term debt are as follows:

Year	Amount
2014	<u>1,500,000</u>
2015	<u>625,000</u>
Total	<u>\$2,125,000</u>

Costs associated with loans outstanding were as follows:

	Years Ended December 31,	
	2012	2013
Interest expense	<u>\$ 286,529</u>	<u>\$ 189,151</u>
Amortization of transaction costs	<u>25,843</u>	<u>18,387</u>
Total interest expense	<u>\$ 312,372</u>	<u>\$ 207,538</u>

4. Accounts Receivable—Trade

Accounts receivable consist of the following:

	December 31,	
	2012	2013
Billed	\$5,175,395	\$3,552,184
Unbilled	1,873,376	1,755,439
Other	10,864	235,469
	<u>\$7,059,635</u>	<u>\$5,543,092</u>
Less: allowance for doubtful accounts	—	(134,811)
	<u>\$7,059,635</u>	<u>\$5,408,281</u>

Unbilled receivables result from contract retainages and revenues that have been earned in advance of billing and can be invoiced at contractually defined intervals, milestones, or at completion of the contract.

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

5. Property and Equipment

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

	December 31,	
	2012	2013
Building	\$ 69,556	\$ 69,556
Equipment	7,222,208	7,239,017
Furniture and fixtures	622,944	562,485
Software	1,185,290	1,092,484
Leasehold improvements	3,196,590	3,168,377
	<u>12,296,588</u>	<u>12,131,919</u>
Less—accumulated depreciation	<u>(9,869,950)</u>	<u>(10,071,210)</u>
	<u>\$ 2,426,638</u>	<u>\$ 2,060,709</u>

Depreciation for the years ended December 31, 2012 and 2013 was approximately \$0.8 million and \$0.5 million, respectively.

6. Intangible Assets

The following is a summary of intangible assets:

	December 31,	
	2012	2013
Patent costs	\$ 2,264,441	\$ 2,496,560
Accumulated amortization	(1,826,602)	(2,208,085)
	<u>\$ 437,839</u>	<u>\$ 288,475</u>

Amortization for the years ended December 31, 2012 and 2013 was approximately \$0.3 million and \$0.4 million, respectively. Estimated aggregate amortization, based on the net value of intangible assets at December 31, 2013, for each of the next five years is as follows:

Year Ending December 31,	
2014	188,616
2015	53,371
2016	24,844
2017	10,578
2018	6,013
	<u>\$283,422</u>

7. Income Taxes

Deferred tax assets and liabilities consist of the following components:

	2012		2013	
	Current	Long-Term	Current	Long-Term
Bad debt and inventory reserve	\$ 41,243	\$ —	\$ 88,077	\$ —
Deferred revenue	—	—	—	59,673
Depreciation and amortization	—	1,005,697	—	1,024,784
Net operating loss carryforwards	—	11,358,044	—	10,896,286
Research and development credits	—	386,161	—	386,161
Accrued liabilities	731,831	—	836,011	—
Deferred compensation	—	123,797	—	163,655
Stock-based compensation	—	1,208,970	—	1,519,513
AMT credit	—	28,555	—	42,711
Total	773,074	14,111,224	924,088	14,092,783
Valuation allowance	(773,074)	(14,111,224)	(924,088)	(14,092,783)
Net deferred tax asset	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

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

	2012	2013
Statutory federal rate	34.00%	34.00%
State tax net of federal benefit	3.73%	3.96%
Change in valuation allowance	(4.16)%	(16.88)%
Incentive stock options	(35.60)%	(41.60)%
Provision to return adjustments	(1.80)%	24.11 %
Meals and entertainment	(0.74)%	(1.33)%
Other Permanent differences	(0.60)%	(4.37)%
Income tax (expense)	<u>(5.17)%</u>	<u>(2.11)%</u>

The income tax expense consists of the following for:

	2012	2013
Current:		
Federal	\$18,268	\$14,071
State	3,149	—
Deferred Federal	—	—
Deferred State	—	—
Income tax expense	<u>\$21,417</u>	<u>\$14,071</u>

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 carryforwards at December 31, 2013 of approximately \$28.7 million expiring at varying dates through 2025. We have research and development tax credit carryforwards at December 31, 2013 of approximately \$0.4 million, which expire at varying dates through 2024.

We have undertaken a formal section 382 study and determined that we do not have a limitation on our net operating loss available to offset income.

The U.S. federal statute of limitations remains open for the year 2005 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. Management believes it is not more likely than not that the deferred tax assets at December 31, 2012 or December 31, 2013 will be realized, and therefore a valuation allowance was established against all such deferred tax assets.

We are evaluating the potential impact of the final Treasury regulations released on September 13, 2013 concerning amounts paid to acquire, produce or improve tangible property and recovery of basis upon disposition. We are determining whether or not any changes in accounting method will be required and if they will result in a material impact to our financial statements. At this time, we do not anticipate there being a material impact.

Windfall equity-based compensation deductions are tracked, but will not be recorded to the balance sheet until management determines it is more likely than not that such amounts will be utilized. As of December 31, 2013, the Company had approximately \$165,000 of windfall stock compensation deductions. If and when realized, the tax benefit associated with these deductions will be credited to additional paid-in capital. These excess benefit deductions are included in the total federal net operating losses disclosed above.

8. Stockholders' Equity

Series A Convertible Preferred Stock

In January 2010, we entered into a transaction with Carilion, in which Carilion agreed to exchange all of its Senior Convertible Promissory Notes in the principal amount of \$5.0 million plus all accrued but unpaid interest, totaling \$1.2 million, for 1,321,514 shares of our newly designated Series A Convertible Preferred Stock. The Series A Convertible Preferred Stock is non-voting, carries a dividend of 6% payable in shares of common stock and maintains a liquidation preference up to \$6.2 million. As of December 31, 2013, 314,525 shares of common stock were issuable to Carilion as dividends and have been recorded in the statement of stockholders' equity. These dividends are issuable on demand. Each share of Series A Convertible Preferred Stock may be converted into one share of our common stock at the option of the holder. We recorded the fair value of the Series A Convertible Preferred Stock, determined based upon the conversion value immediately prior to the exchange, the fair value of the new warrant issued to Carilion (as described below), determined using the Black-Scholes valuation model, and the incremental fair value of the prior warrant due to the re-pricing (as described below) and extension of maturity to stockholders' equity.

Hansen Warrant

In January 2010, we issued 1,247,330 shares of common stock to Hansen, representing 9.9% of our common stock then outstanding. In addition, we issued to Hansen a warrant entitling Hansen to purchase a number of shares of our common stock as necessary for Hansen to maintain a 9.9% ownership interest in our common stock, at an exercise price of \$0.01 per share. During 2012, Hansen did not exercise any of its outstanding warrants. During 2013, Hansen exercised warrants acquiring an additional 32,180 shares. The warrant expired on January 12, 2013 in accordance with its terms. For the years ended December 31, 2012 and 2013, we recognized expense of \$17,190 and \$0, respectively, which is included in operating expenses. We recognized expense based upon the fair market value of our stock at the date the shares were issuable, updated quarterly for non-exercised warrants, to Hansen.

Stock Option Plans

In April 2003, we adopted the Luna Innovations Incorporated 2003 Stock Plan, or the 2003 Plan. Under the 2003 Plan, our Board of Directors was authorized to grant both incentive and non-statutory stock options to our employees, directors and consultants 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 945,472 shares as of December 31, 2013. 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 or the 2006 Plan. Under the 2006 Plan, our Board of Directors is authorized to grant both incentive and non-statutory stock options to purchase common stock and restricted stock awards to our employees, directors, and consultants. Stock option 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 8,872,540 and 10,468,175 shares were available for future grant under the 2006 Plan as of December 31, 2012 and 2013, respectively.

Vesting for employees typically occurs over a five-year period.

Total non-cash stock option expense for the years ended December 31, 2012 and 2013 was \$1.9 million and \$1.2 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, 2012	4,641,039	\$0.35–6.74	\$ 2.23	\$1,509,270	3,206,994	\$ 2.23	\$1,258,740
Forfeited	(64,245)	0.65–5.50	1.91				
Exercised	(182,702)	0.35–1.77	0.38				
Granted	1,028,038	1.40–1.75	1.67				
Balance at December 31, 2012	5,422,130	\$0.35–6.74	\$ 2.19	\$ 639,904	3,775,388	\$ 2.37	\$ 604,292
Forfeited	(693,644)	0.35–6.74	2.08				
Exercised	(137,097)	0.35–1.18	0.56				
Granted	687,840	1.20–1.31	1.29				
Balance at December 31, 2013	<u>5,279,229</u>	<u>\$0.35–6.55</u>	<u>\$ 2.11</u>	<u>\$ 784,154</u>	<u>4,012,378</u>	<u>\$ 2.28</u>	<u>\$ 697,826</u>

- (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-the-money options only. The prices represent the closing price of our Common Stock on the NASDAQ Capital Market on the respective dates.

	Range of Exercise Prices	Options Outstanding			Options Exercisable	
		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, 2012	\$ 0.35–6.74	5,422,130	6.39	\$ 2.19	3,775,388	\$ 2.37
Year ended December 31, 2013	\$ 0.35–6.55	5,279,229	5.88	\$ 2.11	4,012,378	\$ 2.28
		Total intrinsic value of options exercised		Total fair value of options vested		
Year ended December 31, 2012		\$	215,541	\$	1,170,738	
Year ended December 31, 2013		\$	111,595	\$	1,248,067	

For the years ended December 31, 2012 and 2013, the weighted average grant date fair value of options granted was \$1.10 and \$1.29, respectively. We estimate the fair value of options at the grant date using the Black-Scholes model.

We will recognize \$1.6 million over the remaining requisite service period. For all options granted through December 31, 2013, the weighted average remaining service period is 1.7 years.

9. Commitments and Contingencies

Obligation under Operating Leases

We lease facilities in Blacksburg, Charlottesville and Roanoke, Virginia under operating leases that as of December 31, 2013, were scheduled to expire between November 2014 and December 2018. 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 recorded in our selling, general and administrative expense line on our statement of operations totaled approximately \$1.3 million and \$1.0 million, respectively, for the years ended December 31, 2012 and 2013. During 2013, we subleased a portion of the office space formerly occupied by Secure Computing and Communications group (“SCC”) to Mac-B. The amount of the sublease income recognized in 2013 was approximately \$266,000. The sublease continues through April 30, 2014.

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, 2013, under the aforementioned operating leases for each of the next five years are:

2014	1,014,131
2015	503,760
2016	299,635
2017	305,628
2018	311,740
	<u>\$2,434,894</u>

Purchase Commitment

In the fourth quarter of 2013 we executed two non-cancelable purchase orders totaling \$1.4 million for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in the fourth quarter of 2013. At December 31, 2013, approximately \$1.4 million of this commitment remained.

Royalty Agreement

We have licensed certain third-party technologies from vendors for which we owe minimum royalties aggregating \$1.8 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. We contribute 25% of the salary deferral elected by each employee up to a maximum deferral of 10% of annual salary.

We contributed approximately \$250,000 and \$175,000 to the plan for the years ended December 31, 2012 and 2013, 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.

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. Relationship with Major Customers

During the years ended December 31, 2012 and 2013, approximately 66% and 64%, respectively, of our consolidated revenues were attributable to contracts with the U.S. government.

At December 31, 2012 and 2013, receivables with respect to contracts with the U.S. government represented 34% and 25% of total billed trade receivables, respectively.

13. Financial Information About Segments

Our operations are divided into two operating segments: Technology Development and Products 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 Products and Licensing segment develops and sells products or licenses technologies based on commercially viable concepts developed by the Technology Development segment. The Products and Licensing segment derives its revenue from product sales, funded product development and technology licenses.

Our President and 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.

Information about the results of operations for each segment is set forth in the table below. There were no significant inter-segment sales during the two years ended December 31, 2013. There was an insignificant amount of product sales made outside the United States during these two years.

	Year Ended December 31,	
	2012	2013
Technology Development revenue	\$15,126,834	\$11,421,868
Products and Licensing revenue	8,338,967	6,911,707
Total revenue	<u>23,465,801</u>	<u>18,333,575</u>
Technology Development operating loss	(1,703,370)	(3,169,605)
Products and Licensing operating loss	(2,426,707)	(4,865,705)
Total operating loss from continuing operations	<u>(4,130,077)</u>	<u>\$ (8,035,310)</u>
Depreciation, Technology Development	\$ 499,439	\$ 286,894
Depreciation, Products and Licensing	266,327	266,862
Amortization, Technology Development	212,790	197,765
Amortization, Products and Licensing	113,471	183,956

Additional segment information is as follows:

	December 31,	
	2012	2013
Total segment assets:		
Technology Development	\$13,342,725	\$10,208,433
Products and Licensing	7,115,043	9,495,642
Total	<u>\$20,457,768</u>	<u>\$19,704,075</u>
Property plant and equipment and intangible assets, Technology Development	\$ 1,868,235	\$ 1,217,083
Property plant and equipment and intangible assets, Products and Licensing	<u>\$ 996,242</u>	<u>\$ 1,132,101</u>

14. Quarterly Results (unaudited)

The following table sets forth our unaudited historical revenues, operating loss and net (loss) income by quarter during 2012 and 2013.

(Dollars in thousands, except per share amounts)	Quarter Ended							
	March 31, 2012	June 30, 2012	September 30, 2012	December 31, 2012	March 31, 2013	June 30, 2013	September 30, 2013	December 31, 2013
Revenues:								
Technology	\$ 3,943	\$ 3,895	\$ 3,691	\$ 3,598	\$ 2,627	\$ 2,807	\$ 3,130	\$ 2,858
Products and licensing	2,338	1,993	2,021	1,986	1,478	2,024	1,569	1,841
Total revenues	6,281	5,888	5,712	5,584	4,105	4,831	4,699	4,699
Gross Margin	2,533	2,315	2,266	1,778	1,135	1,777	1,677	1,460
Operating loss	(867)	(922)	(1,020)	(1,322)	(2,241)	(1,739)	(1,302)	(2,753)
Loss from continuing operations, net	(712)	(681)	(759)	(1,076)	(1,319)	(1,035)	(775)	(2,379)
Income/(loss) from discontinued operations								
net of income taxes	378	438	539	489	4,105	83	161	356
Net income/(loss)	(334)	(243)	(220)	(587)	2,786	(952)	(614)	(2,023)
Net (loss)/income attributable to common stockholders	<u>\$ (369)</u>	<u>\$ (269)</u>	<u>\$ (254)</u>	<u>\$ (612)</u>	<u>\$ 2,762</u>	<u>\$ (978)</u>	<u>\$ (640)</u>	<u>\$ (2,049)</u>
Net loss per share from continuing operations:								
Basic	\$ (0.05)	\$ (0.05)	\$ (0.05)	\$ (0.08)	\$ (0.09)	\$ (0.07)	\$ (0.05)	\$ (0.16)
Diluted	\$ (0.05)	\$ (0.05)	\$ (0.05)	\$ (0.08)	\$ (0.09)	\$ (0.07)	\$ (0.05)	\$ (0.16)
Net income/(loss) per share from discontinued operations:								
Basic	\$ 0.03	\$ 0.03	\$ 0.04	\$ 0.03	\$ 0.29	\$ 0.01	\$ 0.01	\$ 0.03
Diluted	\$ 0.03	\$ 0.03	\$ 0.04	\$ 0.03	\$ 0.29	\$ 0.01	\$ 0.01	\$ 0.03
Net (loss)/income attributable to common stockholders:								
Basic	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.04)	\$ 0.20	\$ (0.07)	\$ (0.04)	\$ (0.14)
Diluted	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.04)	\$ 0.20	\$ (0.07)	\$ (0.04)	\$ (0.14)
Weighted average shares:								
Basic and Diluted	13,850,667	13,892,816	13,939,938	14,008,772	14,011,814	14,362,494	14,441,707	14,488,060

15. Discontinued Operations

On March 1, 2013, we completed the sale of our SCC which was part of our Technology Development segment, to an unaffiliated third party for a gross sales price of \$6.1 million of cash. Prior to the sale, SCC provided innovative solutions designed to secure critical technologies within the U.S. government. SCC conducted applied research and provided services to the government in this area, with its revenues primarily derived from U.S. government contracts and purchase orders. Of the purchase price, we received approximately \$5.4 million at closing and \$110,000 on December 31, 2013. During December 2013, an additional \$475,000 in purchase price was released to us from escrow and another \$125,000 is in escrow and may be released 18 months, after the closing of the transaction, subject to any indemnification claims of the acquirer. In connection

with the sale, we incurred approximately \$0.9 million in transaction costs that included various charges related to investment banker and legal fees. In addition, the acquirer has entered into a sublease with us for the facilities historically occupied by SCC through April 30, 2014 for a total of \$0.4 million. In the transaction, we sold the equipment, contracts and intellectual property associated with SCC. Approximately 20 employees of SCC transferred to the acquirer. Included in the transaction were current assets of approximately \$0.2 million and long term assets with a net book value of approximately \$0.1 million, at February 28, 2013. SCC accounted for 18.5% of our revenues, and 20.7% of our cost of revenues for the year ended December 31, 2012. We recorded an aggregate after-tax gain on the sale of SCC of \$3.3 million or \$0.20 per diluted share in our results of operations for the year ended December 31, 2013.

Following the sale of SCC, we have continued to act on behalf of the purchaser and bill the government for certain contracts that have not yet been transferred by the government to the purchaser. We record this activity within (loss)/income from discontinued operations. During the year ended December 31, 2013, this amount was \$1.7 million. We expect to continue recording such activity until all of these contracts are transferred to the purchaser by the government.

The operating income from discontinued operations for the year ended December 31, 2013, is the result the allocation of the alternative minimum tax computation on the company's results as a whole at December 31, 2013.

On January 21, 2014, we sold our assets associated with the development of fiber optic shape sensing and localization for the medical field to affiliates of Intuitive Surgical, Inc., for total cash consideration of up to \$30 million, including \$6 million received at closing, and \$6 million to be received within 90 days of closing, and up to \$18 million that may be received in the future based on the achievement of certain technical milestones and royalties on system sales, if any. In the transaction, we sold equipment and intellectual property associated with our shape sensing technology. Ten employees were transferred to Intuitive. Included in the transaction were current assets of totaling approximately \$0.2 million and long term assets with a net book value of approximately \$0.2 million, at December 31, 2013. Our fiber optic shape sensing and localization for the medical field accounted for approximately 12% of our revenues, and 9% of our cost of revenues for the year ended December 31, 2013.

We have reported the results of operations of SCC and our shape sensing business as discontinued operations in our consolidated financial statements. We allocated a portion of the consolidated tax expense to discontinued operations based on the ratio of the discontinued group's income or loss before allocations.

The key components of income/ (loss) from discontinued operations were as follows:

	<u>Year Ended December 31,</u>	
	<u>2012</u>	<u>2013</u>
Net revenues	\$8,883,202	\$5,909,375
Cost of revenues	5,337,336	3,486,200
Operating expenses	574,446	229,745
Income/(loss) before income taxes	2,971,420	2,193,430
Allocated tax expense/(benefit)	1,127,981	879,819
Operating income/(loss) from discontinued operations	1,843,439	1,313,611
Gain on sale, net of \$1.5 million of related income taxes	—	3,391,639
Income from discontinued operations, net of income taxes (\$1.0 million and \$2.4 million, respectively)	<u>\$1,843,439</u>	<u>\$4,705,250</u>

Luna Innovations Incorporated
Valuation and Qualifying Accounts

Column A	<u>Column B</u>	<u>Column C</u>	<u>Column D</u>	<u>Column E</u>	<u>Column F</u>
	Balance at beginning of Period	Charged to costs and expenses	Deductions	Valuation against asset	Balance at end of period
Year Ended December 31, 2013					
Reserves deducted from assets to which they apply:					
Inventory obsolescence	\$ 86,186	\$ —	\$ (11,435)	\$ —	\$ 74,751
Allowances for doubtful Accounts	\$ —	\$134,811	\$ —	\$ —	\$134,811
	\$ 86,186	\$134,811	\$ (11,435)	\$ —	\$209,562
Year Ended December 31, 2012					
Reserves deducted from assets to which they apply:					
Inventory obsolescence	\$ 147,676	\$ —	\$ (61,490)	\$ —	\$ 86,186
Allowances for doubtful Accounts	\$ 22,372	\$ —	\$ (22,372)	\$ —	\$ —
	\$ 170,048	\$ —	\$ (83,862)	\$ —	\$ 86,186

