

LUNA INNOVATIONS INC
Form 10-Q
November 13, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

For the transition period from _____ to _____
COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware 54-1560050
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification Number)
301 First Street SW, Suite 200
Roanoke, VA 24011
(Address of Principal Executive Offices)
(540) 769-8400
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 9, 2017, there were 28,402,887 shares of the registrant's common stock outstanding.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2017
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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Consolidated Balance Sheets

	September 30, 2017 (unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$38,514,437	\$12,802,458
Accounts receivable, net	8,940,405	10,269,012
Inventory	7,300,035	6,848,835
Prepaid expenses and other current assets	924,196	1,375,659
Current assets held for sale	—	5,801,629
Total current assets	55,679,073	37,097,593
Property and equipment, net	3,145,769	3,482,687
Intangible assets, net	3,264,285	3,367,217
Goodwill	502,000	502,000
Long term receivable- sale of HSOR business	4,000,000	—
Other assets	18,024	38,194
Non-current assets held for sale	—	10,509,282
Total assets	\$66,609,151	\$54,996,973
Liabilities and stockholders' equity		
Liabilities:		
Current liabilities:		
Current portion of long-term debt obligations	\$1,833,333	\$1,833,333
Current portion of capital lease obligations	49,070	52,128
Accounts payable	2,188,776	2,954,742
Accrued liabilities	9,586,554	7,913,544
Deferred revenue	897,023	837,906
Current liabilities held for sale	—	2,376,703
Total current liabilities	14,554,756	15,968,356
Long-term deferred rent	1,221,170	1,319,402
Long-term debt obligations	1,057,263	2,420,032
Long-term capital lease obligations	79,246	114,940
Non-current liabilities held for sale	—	84,555
Total liabilities	16,912,435	19,907,285
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, par value \$0.001, 1,321,514 shares authorized, issued and outstanding at September 30, 2017 and December 31, 2016	1,322	1,322
Common stock, par value \$0.001, 100,000,000 shares authorized, 28,402,887 and 27,988,104 shares issued, 27,815,060 and 27,541,277 shares outstanding at September 30, 2017 and December 31, 2016	29,074	28,600
Treasury stock at cost, 587,827 and 446,827 shares at September 30, 2017 and December 31, 2016	(746,007)	(517,987)
Additional paid-in capital	83,204,263	82,451,958
Accumulated deficit	(32,791,936)	(46,874,205)
Total stockholders' equity	49,696,716	35,089,688
Total liabilities and stockholders' equity	\$66,609,151	\$54,996,973

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

Table of ContentsLuna Innovations Incorporated
Consolidated Statements of Operations

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(unaudited)		(unaudited)	
Revenues:				
Technology development	\$4,590,054	\$4,118,245	\$13,428,428	\$11,772,731
Products and licensing	7,052,094	7,066,908	19,593,648	18,301,631
Total revenues	11,642,148	11,185,153	33,022,076	30,074,362
Cost of revenues:				
Technology development	3,491,840	3,068,360	10,045,261	8,986,312
Products and licensing	3,617,547	3,758,765	10,201,459	9,954,987
Total cost of revenues	7,109,387	6,827,125	20,246,720	18,941,299
Gross profit	4,532,761	4,358,028	12,775,356	11,133,063
Operating expense:				
Selling, general and administrative	3,256,074	3,816,679	10,345,964	11,296,389
Research, development and engineering	833,811	812,050	2,581,473	2,789,801
Total operating expense	4,089,885	4,628,729	12,927,437	14,086,190
Operating income/(loss)	442,876	(270,701)	(152,081)	(2,953,127)
Other income/(expense):				
Other expense	(3,389)	(231)	(4,258)	(1,904)
Interest expense	(55,099)	(71,991)	(179,860)	(237,081)
Total other expense	(58,488)	(72,222)	(184,118)	(238,985)
Income/(loss) from continuing operations before income taxes	384,388	(342,923)	(336,199)	(3,192,112)
Income tax (benefit)/expense	(130,977)	44,797	(63,350)	(173,801)
Net income/(loss) from continuing operations	515,365	(387,720)	(272,849)	(3,018,311)
Income/(loss) from discontinued operations, net of income tax (benefit)/expense of \$(349,515), \$(35,095), \$(349,515), and \$209,678.	145,293	(57,358)	(644,241)	342,685
Gain on sale, net of \$1,508,373 of related income taxes	15,096,666	—	15,096,666	—
Net income/(loss) from discontinued operations	15,241,959	(57,358)	14,452,425	342,685
Net income/(loss)	15,757,324	(445,078)	14,179,576	(2,675,626)
Preferred stock dividend	33,699	28,941	97,331	74,731
Net income/(loss) attributable to common stockholders	\$15,723,625	\$(474,019)	\$14,082,245	\$(2,750,357)
Net income/(loss) per share from continuing operations:				
Basic	\$0.02	\$(0.01)	\$(0.01)	\$(0.11)
Diluted	\$0.02	\$(0.01)	\$(0.01)	\$(0.11)
Net income/(loss) per share from discontinued operations:				
Basic	\$0.55	\$0.00	\$0.52	\$0.01
Diluted	\$0.47	\$0.00	\$0.52	\$0.01
Net income/(loss) per share attributable to common stockholders:				
Basic	\$0.57	\$(0.02)	\$0.51	\$(0.10)
Diluted	\$0.48	\$(0.02)	\$0.51	\$(0.10)
Weighted average common shares and common equivalent shares outstanding:				
Basic	27,692,539	27,605,028	27,611,905	27,531,730

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32,714,389 27,605,028 27,611,905 27,531,730

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

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Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2017	2016
	(unaudited)	
Cash flows provided by/(used in) operating activities		
Net income/(loss)	\$ 14,179,576	\$(2,675,626)
Adjustments to reconcile net income/(loss) to net cash used in operating activities		
Depreciation and amortization	2,241,867	2,759,877
Share-based compensation	476,428	665,354
Bad debt expense	40,753	255,522
Loss on disposal of fixed assets	3,640	—
Gain on sale of discontinued operations	(15,096,666)	—
Change in assets and liabilities		
Accounts receivable	2,127,794	(1,197,885)
Inventory	(2,251,236)	964,443
Other current assets	380,858	(381,632)
Accounts payable and accrued expenses	(1,581,608)	(1,055,060)
Deferred revenue	59,980	(120,871)
Net cash provided by/(used in) operating activities	581,386	(785,878)
Cash flows provided by/(used in) investing activities		
Acquisition of property and equipment	(893,698)	(1,433,260)
Intangible property costs	(392,485)	(317,287)
Proceeds from sale of property and equipment	3,000	—
Proceeds from sales of discontinued operations	28,026,528	—
Net cash provided by/(used in) investing activities	26,743,345	(1,750,547)
Cash flows provided by/(used in) financing activities		
Payments on capital lease obligations	(38,752)	(44,404)
Payments of debt obligations	(1,375,000)	(1,375,000)
Repurchase of common stock	(228,020)	(325,060)
Proceeds from the exercise of options	29,020	—
Net cash used in financing activities	(1,612,752)	(1,744,464)
Net increase in cash and cash equivalents	25,711,979	(4,280,889)
Cash and cash equivalents—beginning of period	12,802,458	17,464,040
Cash and cash equivalents—end of period	\$38,514,437	\$13,183,151
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 173,275	\$ 239,347
Cash paid for income taxes	\$ 41,131	\$ 203,305
Non-cash investing and financing activities		
Dividend on preferred stock, 59,469 shares of common stock issuable for the nine months ended September 30, 2017 and 2016	\$ 97,331	\$ 74,731
Capital expenditures funded by capital lease borrowings	\$ —	\$ 157,246
The accompanying notes are an integral part of these consolidated financial statements.		

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Luna Innovations Incorporated
Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Luna Innovations Incorporated (“we,” “Luna Innovations” 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 are a leader in advanced optical technology, providing unique capabilities in high performance fiber optic test products for the telecommunications industry, distributed fiber optic sensing for the aerospace and automotive industries, and custom optoelectronic components and subsystems. We are organized into two reportable segments, which work closely together to turn ideas into products: our Technology Development segment and our Products and Licensing segment. Our business model is designed to accelerate the process of bringing new and innovative technologies to market. We have a history of net losses from operations beginning in 2005. We have historically managed our liquidity through cost reduction initiatives, debt financings, capital markets transactions and the sale of assets.

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial statements and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for annual financial statements. The unaudited consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, consisting of only normal recurring accruals considered necessary to present fairly our financial position at September 30, 2017, results of operations for the three and nine months ended September 30, 2017 and 2016, and cash flows for the nine months ended September 30, 2017 and 2016. The results of operations for the three and nine months ended September 30, 2017, are not necessarily indicative of the results that may be expected for the year ending December 31, 2017.

The consolidated interim financial statements, including our significant accounting policies, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the year ended December 31, 2016, included in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) on March 20, 2017.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between marketplace participants. Various valuation approaches can be used to determine fair value, each requiring different valuation inputs. The following hierarchy classifies the inputs used to determine fair value into three levels:

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 all significant inputs and significant value drivers are observable in active markets

Level 3—Valuations derived from valuation techniques in which one or more significant inputs or 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 our debt approximates fair value, as we consider the floating interest rate on our credit facilities with Silicon Valley Bank (“SVB”) to be at market for similar instruments. Certain non-financial assets and liabilities are measured at fair value on a nonrecurring basis in accordance with U.S. GAAP. This includes items such as non-financial assets and liabilities initially measured at fair value in a business combination and non-financial long-lived asset groups measured at fair value for an impairment assessment. In general, non-financial assets including intangible assets and property and equipment are measured at

fair value when there is an indication of impairment and are recorded at fair value only when any impairment is recognized.

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Net Loss Per Share

Basic per share data is computed by dividing our net loss by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing net income, if applicable, 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 shares of common stock had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

The effect of 5.0 million common stock equivalents (which include outstanding warrants, preferred stock and stock options) are included for the diluted per share data for the three months ended September 30, 2017. The effect of 5.6 million common stock equivalents are not included for the three months ended September 30, 2016 as they are anti-dilutive to earnings per share due to our net loss from continuing operations. The effect of 4.9 million and 5.7 million common stock equivalents are not included for the nine months ended September 30, 2017 and 2016, respectively, as they are considered anti-dilutive to earnings per share due to our net loss from continuing operations. Recently Issued Accounting Pronouncements

Effective January 1, 2017, we adopted Accounting Standards Update ("ASU") No. 2016-09, Improvements to Employee Share-Based Payment Accounting. These amendments apply to several aspects of accounting for share-based compensation including the recognition of excess tax benefits and deficiencies and their related presentation in the statement of cash flows as well as accounting for forfeitures. The adoption of ASU No. 2016-09 did not have a significant impact on our financial condition, results of operations or cash flows.

Effective January 1, 2017, we adopted ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, which simplifies the presentation of deferred taxes by requiring that deferred tax assets and liabilities be classified as noncurrent in any classified balance sheet rather than being separated into current and non-current amounts. The adoption of ASU No. 2015-17 did not have a significant impact on our consolidated financial statements.

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. This update simplifies the subsequent measurement of goodwill. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The accounting standard will be effective for reporting periods beginning after December 15, 2019. We do not expect ASU 2017-04 will have a material impact on our financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230), which addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice in how cash receipts and cash payments are presented in the statement of cash flows. ASU 2016-15 is effective for public entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years, with early adoption permitted. The amendments should be applied retrospectively to all periods presented. We do not expect ASU 2016-15 will have a material impact on our financial statements.

In April 2016, the FASB issued ASU 2016-10, Revenue from contracts with customers: Identifying Performance Obligations and Licensing, to clarify certain aspects of the existing standard specific to how an entity should recognize revenue to depict the transfer of promised goods or services to customers. Certain other ASUs have been issued specific to Topic 606 and our disclosure below includes our assessment of all ASUs specific to Topic 606 in the aggregate. In accordance with this update, we will adopt the requirements of the new standard effective January 1, 2018.

We are finalizing our assessment of the financial impact of Topic 606. To date we have reached the following conclusions specific to the impact of Topic 606. Contracts in our Technology Development segment primarily provide research services. We have concluded that revenue specific to this segment will not be materially impacted upon the adoption of Topic 606 as revenue will continue to be recognized over time using an input model. Contracts in our

Products and Licensing segment generally provide for the following revenue sources: standard product sales, custom product development and sales, product rental, extended warranties, training/service, and certain royalties. We expect revenue for this segment to be recognized using either “point in time” or “over time” based on the revenue source. Based on our analysis to date we expect the pattern of recognition of the customized products to potentially change from “point in time” to “over time” upon the adoption of Topic 606. Our revenue recognized specific to customized products approximates \$10 million annually. This change will result in the acceleration of revenue when compared to existing standards with the cumulative adjustment relating to contracts that are not complete as of December 31, 2017 recognized as an adjustment to opening retained earnings on January 1, 2018. We are continuing to assess the impact of this potential change, or other changes which may be subsequently identified, on our financial statements and current processes and controls. We intend to adopt the standard using the modified retrospective transition method. Under the modified retrospective approach, the new standard

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will, for the period beginning January 1, 2018, apply to net contracts and those that were not completed as of January 1, 2018. For those contracts not completed as of January 1, 2018, this method will result in a cumulative catch-up adjustment to retained earnings. Prior periods will not be retrospectively adjusted, but we will maintain dual reporting for the year of initial application in order to disclose the effect on revenue of adopting the new guidance.

In February 2016, the FASB issued ASU No. 2016-02, Leases, which requires a lessee to recognize in its statement of financial position an asset and liability for most leases with a term greater than 12 months. Lessees should recognize a liability to make lease payments and a right-of-use asset representing the lessee's right to use the underlying asset for the lease term. The amendment is effective for fiscal years ending after December 15, 2018, including interim periods within those fiscal years. We are currently evaluating the impact the adoption of this standard will have on our consolidated financial statements.

2. Discontinued Operations

On August 9, 2017, we completed the sale of our high speed optical receivers ("HSOR") business, which was part of our Products and Licensing segment, to an unaffiliated third party for an initial purchase price of \$33.5 million, of which \$29.5 million in cash has been received, and \$4.0 million was placed into escrow until December 15, 2018 for possible working capital adjustments to the purchase price and potential satisfaction of certain post-closing indemnification obligations (the "Transaction"). The purchase price is subject to adjustment in the future based upon a determination of final working capital, as defined in the asset purchase agreement. The HSOR business was a component of the operations of Advanced Photonix, Inc., which we acquired in May 2015. As part of the Transaction, the buyer also hired approximately 49 of our employees who were engaged in the development, manufacture, and sale of HSOR products in addition to certain corporate administrative functions. The buyer will provide certain transition services to us with respect to infrastructure and administration for which we will pay \$0.3 million per month for a period of five months, for a total of \$1.5 million, following the date of the Transaction. We have recorded this obligation as a reduction of the value of the purchase price. In assessing the fair value of the services expected to be received by us versus those we expect to deliver to the buyer, we concluded that the transition service payments were more closely aligned with the fair value of the assets sold versus the services received and thus should be part of the consideration reconciliation versus operating activities. As of September 30, 2017, \$0.6 million has been paid to the buyer and the remaining \$0.9 million is included in accrued liabilities at September 30, 2017. Our HSOR business accounted for 8.2% of revenues and 10.1% of our cost of revenues for the three months ended September 30, 2017, and 16.1% of revenues and 18.5% of our costs of revenues for the nine months ended September 30, 2017.

We have reported the results of operations of our HSOR business as discontinued operations in our consolidated financial statements. We allocated a portion of the consolidated tax (benefit)/expense to discontinued operations based on the ratio of the discontinued business's loss/(income) before allocations.

The following table presents a summary of the transactions related to the sale.

	September 30, 2017 (unaudited)
Sale price	\$ 33,500,000
Less: transition services payments	(1,500,000)
Adjusted purchase price	32,000,000
Assets held for sale	(16,851,540)
Liabilities held for sale	2,330,052
Transaction costs	(873,473)
Income tax expense	(1,508,373)
Gain on sale of discontinued operations	\$ 15,096,666

Assets and liabilities held for sale as of December 31, 2016 were as follows:

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31, 2016

Assets

Current assets:

Accounts receivable, net	\$4,028,713
Inventory	1,521,400
Prepaid expenses and other current assets	251,516
Total current assets	5,801,629
Property and equipment, net	3,298,151
Intangible assets, net	5,314,046
Goodwill	1,846,331
Other assets	50,754
Total non-current assets	10,509,282
Total assets held for sale	\$16,310,911

Liabilities

Current liabilities:

Accounts payable	\$1,511,450
Accrued liabilities	753,556
Deferred revenue	111,697
Total current liabilities	2,376,703
Long-term deferred rent	84,555
Total non-current liabilities	84,555
Total liabilities held for sale	\$2,461,258

The key components of income from discontinued operations were as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
	(unaudited)		(unaudited)	
Net revenues	\$1,041,310	\$3,433,767	\$6,356,237	\$13,178,475
Cost of revenues	797,678	2,182,495	4,599,042	8,687,783
Operating expenses	447,854	1,342,117	2,750,951	3,901,685
Other expenses	—	(1,608)	—	(36,644)
(Loss)/income before income taxes	(204,222)	(92,453)	(993,756)	552,363
Allocated tax (benefit)/expense	(349,515)	(35,095)	(349,515)	209,678
Operating income/(loss) from discontinued operations	145,293	(57,358)	(644,241)	342,685
Gain on sale, net of related income taxes	15,096,666	—	15,096,666	—
Net income/(loss) from discontinued operations	\$15,241,959	\$(57,358)	\$14,452,425	\$342,685

For the nine months ended September 30, 2017 and 2016, cash flows (used in)/provided by operating activities for discontinued operations were \$(0.8) million and \$0.2 million, respectively. For the nine months ended September 30, 2017 and 2016, cash flows provided by/(used in) investing activities for discontinued operations were \$27.1 million and \$(1.4) million, respectively.

3. Inventory

Inventory consists of finished goods, work-in-process and raw materials valued at the lower of cost (determined on the first-in, first-out basis) or market. We write down inventory for estimated obsolescence or unmarketable inventory in an amount

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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 were as follows:

	September 30, 2017 (unaudited)	December 31, 2016
Finished goods	\$ 2,234,828	\$ 1,952,885
Work-in-process	844,083	714,867
Raw materials	4,221,124	4,181,083
Total inventory	\$ 7,300,035	\$ 6,848,835

4. Accrued Liabilities

Accrued liabilities at September 30, 2017 and December 31, 2016 consisted of the following:

	September 30, 2017 (unaudited)	December 31, 2016
Accrued compensation	\$ 4,377,850	\$ 4,742,760
Income tax payable	1,027,687	—
Claims reserve	1,727,123	1,577,123
Transition services	900,000	—
Accrued sub-contracts	581,544	483,477
Accrued professional fees	70,308	67,719
Deferred rent	141,500	155,138
Royalties	263,625	345,895
Warranty reserve	212,849	185,125
Accrued liabilities - other	284,068	356,307
Total accrued liabilities	\$ 9,586,554	\$ 7,913,544

5. Debt

Silicon Valley Bank Facility

We currently have a Loan and Security Agreement with SVB (the "Credit Facility") under which, as amended on May 8, 2015, we have a term loan with an original borrowing amount of \$6.0 million (the "Original Term Loan"). The Original Term Loan is repayable in 48 monthly installments of \$125,000, plus accrued interest payable monthly in arrears, and unless earlier terminated, is scheduled to mature in May 2020. The Original 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 Original Term Loan at any time, subject to an early termination fee of up to 2% of the amount of prepayment.

In September 2015, we entered into the Waiver and Seventh Loan Modification Agreement, which provided an additional \$1 million of available financing for purchases of equipment through December 31, 2015, which we fully borrowed in December 2015 (the "Second Term Loan" and, together with the Original Term Loan, the "Term Loans"). The Second Term Loan also bears interest at a floating prime rate plus 2% and is to be repaid in 35 monthly installments of \$27,778 plus accrued interest.

The Credit Facility requires us to maintain a minimum cash balance of \$4.0 million and to maintain at each month end a ratio of cash plus 60% of accounts receivable greater than or equal to 1.5 times the outstanding principal of the Term Loans. The Credit Facility also requires us to observe a number of additional operational covenants, including protection and registration of intellectual property rights, and certain customary negative covenants. As of September 30, 2017, we were in compliance with all covenants under the Credit Facility.

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Amounts due under the Credit Facility are secured by substantially all of our assets, including intellectual property, personal property and bank accounts. In addition, the Credit Facility contains 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 Facility and foreclose on the collateral. Furthermore, an event of default under the Credit Facility would result in an increase in the interest rate on any amounts outstanding. As of September 30, 2017, there were no events of default on the Credit Facility.

The aggregate balance under the Term Loans at September 30, 2017 and December 31, 2016, was \$2.9 million and \$4.3 million, respectively. The effective rate of our Term Loan at September 30, 2017 was 6.25%.

The following table presents a summary of debt outstanding as of September 30, 2017 and December 31, 2016:

	September 30, December 31,	
	2017	2016
	(unaudited)	
Silicon Valley Bank Term Loan	\$ 2,916,666	\$ 4,291,666
Less: unamortized debt issuance costs	26,070	38,301
Less: current portion	1,833,333	1,833,333
Total long-term debt	\$ 1,057,263	\$ 2,420,032

The schedule of remaining principal payments under our Term Loans as of September 30, 2017 was as follows:

2017	\$458,333
2018	1,833,333
2019	625,000
	\$2,916,666

6. Capital Stock and Share-Based Compensation

We recognize share-based compensation expense based upon the fair value of the underlying equity award on the date of the grant. For restricted stock awards and restricted stock units, we recognize expense based upon the price of our underlying stock at the date of the grant. We have elected to use the Black-Scholes-Merton option pricing model to value any option or warrant awards granted. We recognize share-based compensation for such awards on a straight-line basis over the requisite service period of the awards. 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. The expected life and estimated post-employment termination behavior is based upon historical experience of homogeneous groups within our company. We also assume an expected dividend yield of zero for all periods, as we have never paid a dividend on our common stock and do not have any plans to do so in the future.

A summary of the stock option activity for the nine months ended September 30, 2017 is presented below:

	Options Outstanding			Aggregate Intrinsic Value (1)	Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average Exercise Price		Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
Balance, January 1, 2017	2,857,114	\$0.61 - \$6.83	\$ 1.89	\$ 107,063	2,367,630	\$ 1.93	\$ 101,071
Granted	80,000	\$1.51 - \$1.54	\$ 1.53				
Exercised	(31,953)	\$0.82 - \$1.38	\$ 0.95				
Canceled	(170,590)	\$1.40 - \$6.83	\$ 2.27				
Balance, September 30, 2017	2,734,571	\$0.61 - \$6.55	\$ 1.87	\$ 585,292	2,619,914	\$ 1.88	\$ 555,926

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The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise (1)price of the option of in-the-money options only. The aggregate intrinsic value is based on the closing price of our common stock on the NASDAQ Capital Market, as applicable, on the respective dates.

At September 30, 2017, the outstanding stock options to purchase an aggregate of 2.7 million shares had a weighted-average remaining contractual term of 4.4 years, and the exercisable stock options to purchase an aggregate of 2.6 million shares had a weighted-average remaining contractual term of 4.3 years.

For the nine months ended September 30, 2017 and 2016 we recognized \$0.5 million and \$0.7 million in share-based compensation expense, respectively, which is included in our selling, general and administrative expense in the accompanying consolidated financial statements. We expect to recognize \$0.1 million in share-based compensation expense over the weighted-average remaining service period of 1.8 years for stock options outstanding as of September 30, 2017.

The following table summarizes the value of our unvested restricted stock awards:

	Number of Unvested Shares	Weighted Average Grant Date Fair Value	Aggregate Value of Unvested Shares
Balance, January 1, 2017	829,998	\$ 1.19	\$988,763
Granted	428,865	\$ 1.54	660,752
Vested	(442,498)	\$ 1.20	(531,853)
Repurchased	—	\$ —	—
Forfeitures	(51,667)	\$ 1.14	(58,917)
Balance, September 30, 2017	764,698	\$ 1.38	\$1,058,745

Restricted Stock Units

We issue restricted stock units ("RSUs"), to our non-employee directors for service on our board of directors. Under our non-employee director compensation policy, continuing non-employee directors receive an annual RSU grant at the time of our annual meeting of stockholders, which grant vests on the earlier of the one year anniversary of the grant or the following annual meeting of stockholders. Under our non-employee director deferred compensation plan, as amended (the "NEDCP") non-employee directors may also elect to receive their annual cash retainers for board and committee service in RSUs which are issued quarterly and vest immediately upon their issuance, subject to deferred settlement in accordance with the NEDCP.

The following is a summary of our RSU activity for the nine months ended September 30, 2017:

	Number of RSUs		Weighted Average Grant Date Fair Value per Share	Intrinsic Value	
	Issued	Unvested		Outstanding	Unvested
Balance, January 1, 2017	393,012	—	\$1.37	\$ 577,728	\$ —
Granted	55,748	—	\$1.57		
Vested	—	—	\$0.00		
Forfeitures	—	—	\$0.00		
Converted	—	—	\$0.00		
Balance, September 30, 2017	448,760	—	\$1.39	\$ 758,404	\$ —

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The following details our equity transactions during the nine months ended September 30, 2017:

	Preferred Stock		Common Stock		Treasury Stock		Additional
	Shares	\$	Shares	\$	Shares	\$	Paid-in Capital
Balance, January 1, 2017	1,321,514	1,322	27,541,277	28,600	446,827	(517,987)	82,451,958
Exercise of stock options	—	—	31,953	32	—	—	819
Share-based compensation	—	—	299,000	299	—	—	476,128
Non-cash compensation	—	—	135,497	136	—	—	178,035
Stock dividends to Carilion Clinic ⁽¹⁾	—	—	—	59	—	—	97,271
Forfeitures of restricted stock grants	—	—	(51,667)	(52)	—	—	—
Repurchase of common stock	—	—	(141,000)	—	141,000	(228,020)	52
Balance, September 30, 2017	1,321,514	1,322	27,815,060	29,074	587,827	(746,007)	83,204,263

The stock dividends payable in connection with Carilion Clinic's Series A Preferred Stock will be issued subsequent to September 30, 2017. For the period from January 12, 2010, the original issue date of the Series A (1)Preferred Stock, through September 30, 2017, the Series A Preferred Stock issued to Carilion has accrued \$1,110,773 in dividends. The accrued and unpaid dividends as of September 30, 2017 will be paid by the issuance of 611,870 shares of our common stock upon Carilion's written request.

Stock Repurchase Program

In May 2016, our board of directors authorized us to repurchase up to \$2.0 million of our common stock through May 31, 2017. As of May 31, 2017, we had repurchased a total of 205,500 shares for an aggregate purchase price of \$0.2 million under this stock repurchase program, after which this stock repurchase program expired.

In September 2017, our board of directors re-instituted the stock repurchase program and authorized us to repurchase up to \$2.0 million of our common stock through September 19, 2018. Our stock repurchase program does not obligate us to acquire any specific number of shares. Under the program, shares may be repurchased in privately negotiated or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. As of September 30, 2017, we had repurchased a total of 50,100 shares for an aggregate purchase price of \$0.1 million under this stock repurchase program. We currently maintain all repurchased shares under these stock repurchase programs as treasury stock.

7. Operating 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 revenues primarily from services.

The Products and Licensing segment derives its revenues from product sales, funded product development and technology licenses.

Through September 30, 2017, our Chief Executive Officer and his direct reports collectively represented our chief operating decision makers, and they evaluated segment performance based primarily on revenues and operating income or loss. The accounting policies of our segments are the same as those described in the summary of significant accounting policies (see Note 1 to our Financial Statements, "Organization and Summary of Significant Accounting Policies," presented in our Annual Report on Form 10-K as filed with the SEC on March 20, 2017).

The table below presents revenues and operating income/(loss) for reportable segments:

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
	(unaudited)		(unaudited)	
Revenues:				
Technology development	\$4,590,054	\$4,118,245	\$13,428,428	\$11,772,731
Products and licensing	7,052,094	7,066,908	19,593,648	18,301,631
Total revenues	\$11,642,148	\$11,185,153	\$33,022,076	\$30,074,362
Technology development operating income/(loss)	\$182,776	\$139,134	\$(77,323)	\$(253,833)
Products and licensing operating income/(loss)	260,100	(409,835)	(74,758)	(2,699,294)
Total operating income/(loss)	\$442,876	\$(270,701)	\$(152,081)	\$(2,953,127)
Depreciation, technology development	\$87,389	\$87,884	\$267,282	\$264,549
Depreciation, products and licensing	\$117,219	\$300,530	\$688,700	\$827,661
Amortization, technology development	\$28,935	\$23,651	\$95,540	\$141,490
Amortization, products and licensing	\$247,522	\$486,209	\$1,178,113	\$1,526,177

Products and licensing depreciation includes amounts from discontinued operations of \$0.1 million and \$0.2 million for the three months ended September 30, 2017 and 2016, respectively. Products and licensing amortization includes amounts from discontinued operations of \$0.1 million and \$0.4 million for the three months ended September 30, 2017 and 2016, respectively. Products and licensing depreciation includes amounts from discontinued operations of \$0.4 million and \$0.5 million for the nine months ended September 30, 2017 and 2016, respectively. Products and licensing amortization includes amounts from discontinued operations of \$0.9 million and \$1.2 million for the nine months ended September 30, 2017 and 2016, respectively.

The table below presents assets for reportable segments:

	September 30,	December 31,
	2017	2016
	(unaudited)	
Total segment assets:		
Technology development	\$30,738,481	\$16,923,090
Products and licensing	35,870,670	38,073,883
Total assets	\$66,609,151	\$54,996,973
Property plant and equipment, and intangible assets, technology development	\$2,427,556	\$2,602,803
Property plant and equipment, and intangible assets, products and licensing	\$4,484,498	\$4,749,144

There are no material inter-segment revenues for any period presented. Total assets for September 30, 2017 include proceeds from the sale of HSOR in the amount of \$33.5 million (which includes a long term receivable of \$4.0 million) allocated evenly between the two segments. For December 31, 2016, the products and licensing segment assets include assets held for sale in the amount of \$16.3 million. Property plant and equipment, and intangible assets excludes HSOR amounts for September 30, 2017 and December 31, 2016.

The U.S. government accounted for 45% and 39% of total consolidated revenues for the three months ended September 30, 2017 and 2016, respectively, and for 45% and 42% of total consolidated revenues for the nine months ended September 30, 2017 and 2016, respectively.

International revenues (customers outside the United States) accounted for 19% and 15% of total consolidated revenues for the three months ended September 30, 2017 and 2016, respectively, and 20% and 18% of the total consolidated revenues for the nine months ended September 30, 2017 and 2016, respectively. No single country, outside of the United States, represented more than 10% of total revenues in the three and nine months ended September 30, 2017 and 2016.

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8. Contingencies and Guarantees

We are from time to time involved in certain legal proceedings in the ordinary course of conducting our business. While the ultimate liability pursuant to these actions cannot currently be determined, we believe it is not reasonably possible that these legal proceedings will have a material adverse effect on our financial position or results of operations.

In September 2014, we received a preliminary audit report from the Defense Contract Audit Agency (the "DCAA"), with respect to our 2007 incurred cost submission and questioning \$0.8 million of claimed costs that the DCAA believes are expressly unallowable under the Federal Acquisition Regulations and, therefore, subject to potential penalty. In June 2015, we received from the Defense Contract Management Agency ("DCMA") a final determination and demand for payment of penalties, interest, and over billing in the aggregate amount of \$1.1 million. In July 2015, we filed an appeal with the Armed Services Board of Contract Appeals ("ASBCA"). In January 2017, a hearing was held before the ASBCA. No ruling has yet been issued with respect to our appeal. In April 2017, we made a settlement offer of \$150,000 to the DCMA, and we have accrued that amount in our financial statements as of September 30, 2017. The DCMA notified us in May 2017 that it has declined our settlement offer. The appeals process remains ongoing.

In the third quarter of 2016 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. At September 30, 2017, approximately \$0.3 million of this commitment remained and is expected to be delivered by February 28, 2018.

We have entered into indemnification agreements with our officers and directors, to the extent permitted by law, pursuant to which we have agreed to reimburse the officers and directors for legal expenses in the event of litigation and regulatory matters. The terms of these indemnification agreements provide for no limitation to the maximum potential future payments. We have a directors and officers insurance policy that may, in certain instances, mitigate the potential liability and payments.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Quantitative and Qualitative Disclosures About Market Risk" under Items 2 and 3, respectively, of Part I of this report, and the section entitled "Risk Factors" under Item 1A of Part II of this report, may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. All statements other than statements of historical fact are "forward-looking statements" for purposes of these statutes, including those relating to future events or our future financial performance. In some cases, you can identify these forward looking statements by words such as "intends," "will," "plans," "anticipates," "expects," "may," "might," "estimates," "believes," "should," "projects," "potential" or "continue," or the negative of those words and other comparable words, and other words or terms of similar meaning in connection with any discussion of future operating or financial performance. Similarly, statements that describe our business strategy, goals, prospects, opportunities, outlook, objectives, plans or intentions are also forward-looking statements. These statements are only predictions and may relate to, but are not limited to, expectations of future operating results or financial performance, capital expenditures, introduction of new products, regulatory compliance and plans for growth and future operations, as well as assumptions relating to the foregoing. These statements are based on current expectations and assumptions regarding future events and business performance and involve known and unknown risks, uncertainties and other factors that may cause actual events or results to be materially different from any future events or results expressed or implied by these statements. These factors include those set forth in the following discussion and within Item 1A "Risk Factors" of this Quarterly Report on Form 10-Q and elsewhere within this report.

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

Overview of Our Business

We are a leader in advanced optical technology, providing unique capabilities in high performance fiber optic test products for the telecommunications industry, distributed fiber optic sensing for the aerospace and automotive industries, and custom optoelectronic components and subsystems. Our distributed fiber optic sensing products provide critical stress, strain and temperature information to designers and manufacturers working with advanced materials. Our custom optoelectronic products are sold to scientific instrumentation manufacturers for various applications such as metrology, missile guidance, flame monitoring, and temperature sensing. In addition, we provide applied research services, typically under research programs funded by the U.S. government, in areas of advanced 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 for government funded projects. We continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. We are organized into two main business segments, the Products and Licensing segment and the Technology Development segment. Our Products and Licensing segment develops, manufactures and markets fiber optic sensing products, as well as test & 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 61% and 63% of our total revenues for the three months ended

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September 30, 2017 and 2016, respectively, and 59% and 61% of our total revenues for the nine months ended September 30, 2017 and 2016, respectively. The change in revenue mix was primarily a result of continued growth of our Technology Development business segment. The approximate value of our Products and Licensing segment backlog was \$6.9 million at September 30, 2017 and \$7.2 million at December 31, 2016.

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The Technology Development segment performs applied research principally in the areas of sensing and instrumentation, advanced materials and health sciences. This segment comprised 39% and 37% of total revenues for the three months ended September 30, 2017 and 2016, respectively, and 41% and 39% of our total revenues for the nine months ended September 30, 2017 and 2016, respectively. Most of the government funding for our Technology Development segment is derived from the Small Business Innovation Research ("SBIR") program coordinated by the U.S. Small Business Administration ("SBA"). The Technology Development segment revenues have historically accounted for a large portion of total revenues, and we expect that they will continue to represent a significant portion of total revenues for the foreseeable future. The Technology Development segment revenues were \$4.6 million and \$4.1 million for the three months ended September 30, 2017 and 2016, respectively, and \$13.4 million and \$11.8 million for the nine months ended September 30, 2017 and 2016, respectively. 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. government 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 \$27.3 million at September 30, 2017 and \$17.6 million at December 31, 2016.

Revenues from product sales have historically been mostly derived from the sales of our optoelectronic components and from the sales of 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 revenues in the near term. 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 & 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, as we develop and commercialize new products, we expect these revenues will reflect a broader and more diversified mix of products.

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.

Reductions in government spending may impact the availability of new program awards in the future. For example, the Budget Control Act commits the U.S. government to reduce the federal deficit by \$1.2 trillion over ten years through a combination of automatic, across-the-board spending cuts and caps on discretionary spending, or sequestration. Automatic across-the-board cuts required by sequestration could have a material adverse effect on our Technology Development segment revenues and, consequently, our results of operations. While the exact manner in which sequestration will impact our business is unclear, funding for programs in which we participate could be reduced, delayed or canceled. Our ability to obtain new contract awards also could be negatively affected.

Recent Developments

On August 9, 2017, we sold our assets associated with the high speed optical receiver ("HSOR") business to a third party, for total cash consideration of \$33.5 million, including \$29.5 million received at closing and \$4.0 million placed into escrow until December 15, 2018 for possible working capital adjustments to the purchase price and potential satisfaction of certain post-closing indemnification obligations. As part of the transaction, the buyer also hired 49 of our employees who were engaged in the development, manufacture, and sale of HSOR products in addition to certain corporate administrative functions. The buyer will provide certain transition services to us with respect to infrastructure and administration for which we will pay \$0.3 million per month for a period of five months following the date of the transaction. We have recorded this obligation as a reduction of the value of the purchase price. As of September 30, 2017, \$0.6 million has been paid to the buyer and the remaining \$0.9 million is included in our accrued

liabilities.

Our revenues recognized related to the HSOR business were \$1.0 million and \$3.4 million for the three months ended September 30, 2017 and 2016, respectively, and \$6.4 million and \$13.2 million for the nine months ended September 30, 2017 and 2016, respectively.

Our sale of the HSOR business has significantly increased our capital resources, and we currently intend to use a portion of the proceeds from the sale to invest in expanding our fiber optic sensing business. However, the sale of the HSOR business is expected to result in lower revenues, primarily from reduced product sales, than we have experienced in prior periods until, if

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ever, we can increase revenues from our remaining businesses significantly. As a result, we may incur greater net losses and reduced cash flows from operations than we have in recent periods.

Description of Revenues, Costs and Expenses

Revenues

We generate revenues from technology development, product sales and commercial product development and licensing activities. We derive Technology Development segment 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. The Technology Development segment revenues represented 39% and 37% of total revenues for the three months ended September 30, 2017 and 2016, respectively, and 41% and 39% of our total revenues for the nine months ended September 30, 2017 and 2016, respectively.

The Products and Licensing segment revenues reflect amounts that we receive from sales of our products or development of products for third parties and, to a lesser extent, fees paid to us in connection with licenses or sub-licenses of certain patents and other intellectual property, and represented 61% and 63% of our total revenues for the three months ended September 30, 2017 and 2016, respectively, and 59% and 61% of our total revenues for the nine months ended September 30, 2017 and 2016, respectively. Product and licensing revenues decreased as a percentage of our total revenues primarily a result of continued growth of our Technology Development business segment during the three and nine months ended September 30, 2017 compared to the three and nine months ended September 30, 2016.

Cost of Revenues

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

Cost of revenues associated with our Products and Licensing segment 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

Interest expense is composed of interest paid under our term loans as well as interest accrued on our capital lease obligations.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or judgments.

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Our critical accounting policies are described in the Management's Discussion and Analysis section and the notes to our audited consolidated financial statements previously included in our Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the Securities and Exchange Commission ("SEC") on March 20, 2017. Effective January 1, 2017, we adopted Accounting Standards Update ("ASU") No. 2016-09, Improvements to Employee Share-Based Payment Accounting. The amendments apply to several aspects of accounting for share-based compensation including the recognition of excess tax benefits and deficiencies and their related presentation in the statement of cash flows as well as accounting for forfeitures. The adoption of ASU No. 2016-09 did not have a significant impact on our financial condition, results of operations or cash flows. There have been no other material changes to the description of our critical accounting policies as described in our Form 10-K as filed with the SEC on March 20, 2017.

Results of Operations

Three Months Ended September 30, 2017 Compared to Three Months Ended September 30, 2016

Revenues

	Three Months Ended September 30,		\$ Difference	% Difference	
	2017	2016			
Revenues:					
Technology development	\$4,590,054	\$4,118,245	\$471,809	11	%
Products and licensing	7,052,094	7,066,908	(14,814)	0	%
Total revenues	\$11,642,148	\$11,185,153	\$456,995	4	%

Revenues from our Technology Development segment for the three months ended September 30, 2017 increased \$0.5 million, or 11%, to \$4.6 million compared to \$4.1 million for the three months ended September 30, 2016. The increase in Technology Development segment revenues continues a growth trend experienced throughout 2016 and into 2017 largely driven by successes in Phase 2 SBIR awards. The increase for the three months ended September 30, 2017 compared to the three months ended September 30, 2016 was realized primarily in our intelligent systems research group. As Phase 2 contracts generally have a performance period of a year or more, we currently expect revenues to remain at a similar level for the near term.

Our Products and Licensing segment included revenues from sales of test & measurement systems, primarily representing sales of our ODiSI, Optical Vector Analyzer, and Optical Backscatter Reflectometer platforms, optical components and sub-assemblies and sales of Terahertz sensing systems. Products and Licensing segment revenues remained substantially unchanged at \$7.1 million for the three months ended September 30, 2017 and 2016.

Cost of Revenues and Gross Profit

	Three Months Ended September 30,		\$ Difference	% Difference	
	2017	2016			
Cost of revenues:					
Technology development	\$3,491,840	\$3,068,360	\$423,480	14	%
Products and licensing	3,617,547	3,758,765	(141,218)	(4)	%
Total cost of revenues	7,109,387	6,827,125	282,262	4	%
Gross profit	\$4,532,761	\$4,358,028	\$174,733	4	%

The cost of Technology Development segment revenues for the three months ended September 30, 2017 increased \$0.4 million, or 14%, to \$3.5 million compared to \$3.1 million for the three months ended September 30, 2016. The increase in cost of Technology Development segment revenues was attributable to additional headcount and the increased utilization of subcontractors to support the growth in our research contracts.

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The cost of revenues associated with our Products and Licensing segment decreased by \$0.1 million, or 4%, to \$3.6 million for the three months ended September 30, 2017 compared to \$3.8 million for the three months ended September 30, 2016. This slight decrease in cost of revenues resulted from lower manufacturing overhead costs associated with our optoelectronic components products. Our overall gross margin remained substantially unchanged at 39% for the three months ended September 30, 2017 and 2016.

Operating Expense

	Three Months Ended		\$	%
	September 30,			
	2017	2016	Difference	Difference
Operating expense:				
Selling, general and administrative	\$3,256,074	\$3,816,679	\$(560,605)	(15)%
Research, development and engineering	833,811	812,050	21,761	3%
Total operating expense	\$4,089,885	\$4,628,729	\$(538,844)	(12)%

Our selling, general and administrative expense decreased \$0.6 million, or 15%, to \$3.3 million for the three months ended September 30, 2017 compared to \$3.8 million for the three months ended September 30, 2016. The decrease in selling, general and administrative expense was primarily due to a \$0.2 million decrease in bad debt expense and a \$0.2 million decrease in sales and marketing expenses resulting from lower headcount in 2017.

Research, development and engineering expense remained substantially unchanged at \$0.8 million for the three months ended September 30, 2017 and 2016.

Interest Expense

Interest expense was \$0.1 million during each of the three months ended September 30, 2017 and 2016. During the three months ended September 30, 2017, our average outstanding balance on our term loans was \$3.1 million as compared to \$4.9 million for the three months ended September 30, 2016.

Income Tax (Benefit)/Expense From Continuing Operations

The income tax benefit for the three months ended September 30, 2017 was \$0.1 million, which resulted in an effective tax rate from continuing operations of (34.0%), as compared to an immaterial income tax expense, based on an effective tax rate of 13.1%, from continuing operations for the three months ended September 30, 2016. The decrease in our effective tax rate resulted from the cumulative impact of the tax benefit associated with continuing operations for the nine months ended September 30, 2017, as the intraperiod allocation of income taxes from discontinued operations resulted from the sale of the HSOR business during the three months ended September 30, 2017, and accordingly, the year-to-date value was recognized in the current period.

Net Income/(Loss) From Continuing Operations

During the three months ended September 30, 2017, we recognized income from continuing operations before income taxes of \$0.4 million compared to a loss from continuing operations before income taxes of \$0.3 million for the three months ended September 30, 2016. After tax, our net income from continuing operations was \$0.5 million for the three months ended September 30, 2017, compared to a net loss from continuing operations of \$0.4 million for the three months ended September 30, 2016.

Net Income/(Loss) From Discontinued Operations

For the three months ended September 30, 2017, we recognized net income from discontinued operations of \$15.2 million compared to a net loss from discontinued operations of \$0.1 million for the three months ended September 30, 2016. For the three months ended September 30, 2017, our net income from discontinued operations included \$0.1 million associated with the operations of the HSOR business prior to its sale in addition to a \$15.1 million after tax gain recognized on the sale of the HSOR business. For the three months ended September 30, 2016, our net loss from discontinued operations included a \$0.1 million loss associated with the operations of the HSOR business.

Table of ContentsNine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016
Revenues

	Nine Months Ended September 30,		\$ Difference	% Difference	
	2017	2016			
Revenues:					
Technology development	\$ 13,428,428	\$ 11,772,731	\$ 1,655,697	14	%
Products and licensing	19,593,648	18,301,631	1,292,017	7	%
Total revenues	\$33,022,076	\$30,074,362	\$2,947,714	10	%

Technology Development segment revenues increased \$1.7 million, or 14%, to \$13.4 million for the nine months ended September 30, 2017 compared to \$11.8 million for the nine months ended September 30, 2016. The increase for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016 was realized primarily in our intelligent systems, nanomaterials and biomedical technologies groups.

Products and Licensing segment revenues increased \$1.3 million, or 7%, to \$19.6 million for the nine months ended September 30, 2017 compared to \$18.3 million for the nine months ended September 30, 2016. The increase in Products and Licensing segment revenues was primarily driven by an increase in our sales of optical backscatter reflectometer instruments and optoelectronic components.

Cost of Revenues and Gross Profit

	Nine Months Ended September 30,		\$ Difference	% Difference	
	2017	2016			
Cost of revenues:					
Technology development	\$ 10,045,261	\$ 8,986,312	\$ 1,058,949	12	%
Products and licensing	10,201,459	9,954,987	246,472	2	%
Total cost of revenues	20,246,720	18,941,299	1,305,421	7	%
Gross profit	12,775,356	\$ 11,133,063	\$ 1,642,293	15	%

Costs of Technology Development segment revenues increased \$1.1 million, or 12%, to \$10.0 million for the nine months ended September 30, 2017, compared to \$9.0 million the nine months ended September 30, 2016. This increase was primarily driven by increases in direct labor and subcontractor costs over the same period to support the growth in research projects.

Costs of Products and Licensing segment revenues increased \$0.2 million, or 2%, to \$10.2 million for the nine months ended September 30, 2017 compared to \$10.0 million for the nine months ended September 30, 2016. The increase in product and licensing costs is attributable to the component costs associated with increased volume of optical backscatter reflectometer instrument sales during the nine months ended September 30, 2017. Products and Licensing segment costs increased in accordance with the increase in Products and Licensing segment revenues over the same period, taking into account the gross margin effect of the product mix. Our overall gross margin for the nine months ended September 30, 2017 increased to 39% compared to 37% for the nine months ended September 30, 2016.

Operating Expense

	Nine Months Ended September 30,		\$ Difference	% Difference	
	2017	2016			

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Operating expense:

Selling, general and administrative	\$10,345,964	\$11,296,389	\$(950,425)	(8))%
Research, development and engineering	2,581,473	2,789,801	(208,328)	(7))%
Total operating expense	\$12,927,437	\$14,086,190	\$(1,158,753)	(8))%

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Selling, general and administrative expenses decreased \$1.0 million, or 8%, to \$10.3 million for the nine months ended September 30, 2017 compared to \$11.3 million for the nine months ended September 30, 2016. The decrease in selling, general and administrative expenses year to date is primarily related to a \$0.2 million decrease in bad debt expense, a \$0.2 million decrease in share based compensation expense, and a \$0.4 million decrease in sales and marketing costs in our Lightwave division driven by reduction in personnel and reduction in commissions related to a shift in sales to areas without distributors or salesmen.

Research, development and engineering expense decreased \$0.2 million, or 7%, to \$2.6 million for the nine months ended September 30, 2017 compared to \$2.8 million for the nine months ended September 30, 2016 due to decreased engineering costs in internal research for our Terahertz product as more engineering time was spent on externally funded research activities and, accordingly, included in Technology Development cost of revenues.

Interest Expense

Interest expense for each of the nine months ended September 30, 2017 and 2016 was \$0.2 million. During the first nine months of 2017, our average outstanding loan balance was \$3.5 million as compared to \$5.4 million for the nine months ended September 30, 2016.

Income Tax Benefit

The income tax benefit for the nine months ended September 30, 2017 was \$0.1 million, which resulted in an effective tax rate from continuing operations of 18.8%, as compared to an income tax benefit of \$0.2 million, reflecting an effective tax rate of 5.4%, from continuing operations for the nine months ended September 30, 2016. The increase in our effective tax rate for continuing operations for 2017 as compared to 2016, was primarily due to an increase in the intra-period allocation of tax benefit from discontinued operations.

Net Loss From Continuing Operations

During the nine months ended September 30, 2017 we incurred a loss from continuing operations before income taxes of \$0.3 million compared to a loss from continuing operations before income taxes of \$3.2 million during the nine months ended September 30, 2016. After tax, our net loss from continuing operations was \$0.3 million for the nine months ended September 30, 2017, compared to a net loss from continuing operations of \$3.0 million for the nine months ended September 30, 2016.

Net Income From Discontinued Operations

For the nine months ended September 30, 2017, we recognized net income from discontinued operations of \$14.5 million compared to \$0.3 million for the nine months ended September 30, 2016. Net income from discontinued operations for the nine months ended September 30, 2017 included an after tax gain of \$15.1 million recognized on the sale of the HSOR business offset by an after tax loss of \$0.6 million associated with the operations of the HSOR business prior to its sale. Net income from discontinued operations for the nine months ended September 30, 2016 included the after tax income of \$0.3 million associated with the operations of HSOR during the period.

Liquidity and Capital Resources

At September 30, 2017, our total cash and cash equivalents were \$38.5 million.

We currently have a Loan and Security Agreement with Silicon Valley Bank ("SVB") under which we have two term loans with an aggregate original borrowing amount of \$7.0 million. As of September 30, 2017, these term loans had an aggregate outstanding principal balance of \$2.9 million. One term loan, with a balance of \$0.4 million as of September 30, 2017, matures on December 1, 2018. The other term loan, with a balance of \$2.5 million as of

September 30, 2017, matures on May 1, 2019. The term loans bear interest at a floating prime rate plus 2%. We may prepay amounts due under the term loans at any time, subject to prepayment penalties of up to 2% of the amount of prepayment. Amounts due under the term loans are secured by substantially all of our assets, including intellectual property, personal property and bank accounts. The term loans 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

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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 facility and foreclose on the collateral. Furthermore, an event of default under the credit facility would result in an increase in the interest rate on any amounts outstanding. As of September 30, 2017, we were in compliance with all covenants under the Loan and Security Agreement.

We believe that our cash balance as of September 30, 2017 will provide adequate liquidity for us to meet our working capital needs over the next twelve months. Additionally, we believe that should we have the need for increased capital spending to support our planned growth, we will be able to fund such growth through either third-party financing on competitive market terms or through our available cash.

Discussion of Cash Flows

Recent Activity

	Nine Months Ended		
	September 30,		
	2017	2016	\$ Difference
Net cash provided by/(used in) operating activities	\$581,386	\$(785,878)	\$1,367,264
Net cash provided by/(used in) investing activities	26,743,345	(1,750,547)	28,493,892
Net cash used in financing activities	(1,612,752)	(1,744,464)	131,712
Net increase/(decrease) in cash and cash equivalents	\$25,711,979	\$(4,280,889)	\$29,992,868

During the first nine months of 2017, operations provided \$0.6 million of cash, as compared to the same period in 2016 in which operations used \$0.8 million of cash. During the first nine months of 2017, net cash provided by operating activities consisted of our net income of \$14.2 million, which included a gain on the sale of our HSOR business, net of income tax, of \$15.1 million, non-cash charges for depreciation and amortization of \$2.2 million and share-based compensation of \$0.5 million, and a net cash outflow of \$1.3 million from changes in working capital (principally driven by a decrease in accounts payable and accrued expenses of \$1.6 million and an increase in inventory of \$2.3 million, partially offset by a reduction in accounts receivable of \$2.1 million).

During the first nine months of 2016, the \$0.8 million of cash used in operating activities consisted of our net loss of \$2.7 million which included charges for depreciation and amortization of \$2.8 million and share-based compensation of \$0.7 million. Additionally, changes in working capital resulted in a net cash outflow of \$1.8 million, principally driven by a reduction in accounts payable and accrued liabilities of \$1.1 million, a decrease in inventory of \$1.0 million, an increase in other current assets of \$0.4 million, and an increase of \$1.2 million in accounts receivable.

Our cash from investing activities for the nine months ended September 30, 2017 and 2016 included purchases of equipment, capitalized costs associated with the prosecution of patents as well as proceeds from the sale of our HSOR business in August 2017. Cash provided by investing activities for the nine months ended September 30, 2017 included proceeds from the sale of our HSOR business of \$28.0 million, partially offset by \$0.9 million of fixed asset additions and \$0.4 million of capitalized intellectual property costs. Cash used in investing activities for the nine months ended September 30, 2016 included fixed asset additions of \$1.4 million and capitalized intellectual property costs of \$0.3 million.

Net cash used in financing activities during the nine months ended September 30, 2017 and 2016 included the repayment of the long term debt and repayments of capital lease obligations. In the aggregate, these activities resulted in net cash outflows of \$1.6 million and \$1.7 million for the nine months of 2017 and 2016, respectively.

Off-Balance Sheet Arrangements

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. Our exposure to market risk is limited to interest rate fluctuations due to changes in the general level of U.S. interest rates.

Interest Rate Risk

We do not use derivative financial instruments as a hedge against interest rate fluctuations, and, as a result, interest income earned on our cash and cash equivalents and short-term investments is subject to changes in interest rates. However, we believe that the impact of these fluctuations does not have a material effect on our financial position due to the immediately available liquidity or short-term nature of these financial instruments.

We are exposed to interest rate fluctuations as a result of our term loans with SVB having a variable interest rate. We do not currently use derivative instruments to alter the interest rate characteristics of our debt. For the principal amount of \$2.9 million outstanding under the term loans as of September 30, 2017, a change in the interest rate by one percentage point for one year would result in a change in our annual interest expense of \$29,167.

Although we believe that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in our credit quality, composition of our balance sheet and other business developments that could affect our interest rate exposure. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

Foreign Currency Exchange Rate Risk

As of September 30, 2017, all payments made under our research contracts have been denominated in U.S. dollars. Our product sales to foreign customers are also generally denominated in U.S. dollars, and we generally do not receive payments in foreign currency. As such, we are not directly exposed to significant currency gains or losses resulting from fluctuations in foreign exchange rates.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which are controls and other procedures that are designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. In addition, the design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. Based on this evaluation, our principal executive officer and our principal financial officer have concluded that, as of September 30, 2017, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended September 30, 2017 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In June 2015, we received a letter of final determination from the Defense Contract Management Agency ("DCMA") regarding the allowability of certain costs we included in our billings under cost-plus type research contracts during 2007. In conjunction with the DCMA's determination of those costs as expressly unallowable under the provisions of the Federal Acquisition Regulations, the DCMA assessed penalties and interest to us totaling \$1.1 million. In July 2015, we filed an appeal of the assessed penalties and interest with the Armed Services Board of Contract Appeals ("ASBCA"). A hearing was held with respect to this appeal in January 2017, and a decision has not yet been reached by ASBCA. In April 2017, we made a settlement offer of \$150,000 to DCMA, and we have accrued that amount in our financial statements as of September 30, 2017. In May 2017, the DCMA declined our settlement offer. The appeals process remains ongoing.

For additional information regarding our legal proceedings, please refer to our Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on March 20, 2017.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below before deciding whether to invest in our common stock. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also impair our business operations and financial results. If any of the following risks actually occurs, our business, financial condition or results of operations could be adversely affected. In such case, the trading price of our common stock could decline and you could lose all or part of your investment. Our filings with the SEC also contain forward-looking statements that involve risks or uncertainties. Our actual results could differ materially from those anticipated or contemplated by these forward-looking statements as a result of a number of factors, including the risks we face described below, as well as other variables that could affect our operating results. Past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

RISKS RELATING TO OUR BUSINESS GENERALLY

Our technology is subject to a license from Intuitive Surgical, Inc., which is revocable in certain circumstances. Without this license, we cannot continue to market, manufacture or sell our fiber-optic products.

As a part of the sale of certain assets to Intuitive Surgical, Inc. ("Intuitive") in 2014, we entered into a license agreement with Intuitive pursuant to which we received rights to use all of our transferred technology outside the field of medicine and in respect of our existing non-shape sensing products in certain non-robotic medical fields. This license back to us is revocable if after notice and certain time periods, we were to (i) challenge the validity or enforceability of the transferred patents and patent applications, (ii) commercialize our fiber optical shape sensing and localization technology in the field of medicine (except to perform on a development and supply project for Hansen Medical, Inc.), (iii) violate our obligations related to our ability to sublicense in the field of medicine or (iv) violate our confidentiality obligations in a manner that advantages a competitor in the field of medicine and not cure such violation. Maintaining this license is necessary for us to conduct our fiber-optic products business, both for our telecom products and our ODiSI sensing products. If this license were to be revoked by Intuitive, we would no longer be able to market, manufacture or sell these products which would severely limit our ability to continue operations.

We depend on third-party vendors for specialized components in our manufacturing operations, making us vulnerable to supply shortages and price fluctuations that could harm our business.

We primarily rely on third-party vendors for the manufacture of the specialized components used in our products. The highly specialized nature of our supply requirements poses risks that we may not be able to locate additional sources of the specialized components required in our business. For example, there are few manufacturers who produce the special lasers used in our optical test equipment. Our reliance on these vendors subjects us to a number of risks that

could negatively affect our

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ability to manufacture our products and harm our business, including interruption of supply. Although we are now manufacturing tunable lasers in low-rate initial production, we expect our overall reliance on third-party vendors to continue. Any significant delay or interruption in the supply of components, or our inability to obtain substitute components or materials from alternate sources at acceptable prices and in a timely manner could impair our ability to meet the demand of our customers and could harm our business.

We depend upon outside contract manufacturers for a portion of the manufacturing process for some of our products. Our operations and revenue related to these products could be adversely affected if we encounter problems with these contract manufacturers.

Many of our products are manufactured internally. However, we also rely upon contract manufacturers to produce the finished portion of some of our optoelectronic components and certain lasers. Our reliance on contract manufacturers for these products makes us vulnerable to possible capacity constraints and reduced control over delivery schedules, manufacturing yields, manufacturing quality control and costs. If the contract manufacturer for our products were unable or unwilling to manufacture our products in required volumes and at high quality levels or to continue our existing supply arrangement, we would have to identify, qualify and select an acceptable alternative contract manufacturer or move these manufacturing operations to internal manufacturing facilities. An alternative contract manufacturer may not be available to us when needed or may not be in a position to satisfy our quality or production requirements on commercially reasonable terms, including price. Any significant interruption in manufacturing our products would require us to reduce the supply of products to our customers, which in turn would reduce our revenue, harm our relationships with the customers of these products and cause us to forego potential revenue opportunities. As a provider of contract research to the U.S. government, we are subject to federal rules, regulations, audits and investigations, the violation or failure of which could adversely affect our business.

We must comply with and are affected by laws and regulations relating to the award, administration and performance of U.S. government contracts. Government contract laws and regulations affect how we do business with our government customers and, in some instances, impose added costs on our business. A violation of a specific law or regulation could result in the imposition of fines and penalties, termination of our contracts or debarment from bidding on contracts. In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the U.S. government may terminate any of our government contracts and, in general, subcontracts, at their convenience, as well as for default based on performance.

In addition, U.S. government agencies, including the Defense Contract Audit Agency and the Department of Labor, routinely audit and investigate government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The U.S. government also may review the adequacy of, and a contractor's compliance with, its internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers the inclusion of certain claimed costs deemed to be expressly unallowable, or improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government. In addition, our reputation could suffer serious harm if allegations of impropriety were made against us. In June 2015, we received a determination from the Defense Contract Management Agency ("DCMA") of expressly unallowable costs included in our claimed costs for the 2007 contract year. As a result of that determination, the DCMA assessed us penalties, interest and over billings of \$1.1 million. We have appealed that assessment, and our appeal is currently pending. In April 2017, we also made a settlement offer of \$150,000 to the DCMA, which the DCMA subsequently declined. Depending on the outcome of this appeal and the response to our settlement offer, we could be required to make payments that have a material adverse effect on our financial position. In addition to the risk of government audits and investigations, U.S. government contracts and grants impose requirements on contractors and grantees relating to ethics and business practices, which carry civil and criminal penalties including monetary fines, assessments, loss of the ability to do business with the U.S. government and certain other criminal penalties.

We may also be prohibited from commercially selling certain products that we develop under our Technology Development segment or related products based on the same core technologies if the U.S. government determines that the commercial availability of those products could pose a risk to national security. For example, certain of our wireless technologies have been classified as secret by the U.S. government and as a result we cannot sell them commercially. Any of these determinations would limit our ability to generate product sales and license revenues.

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We rely and will continue to rely on contracts and grants awarded under the SBIR program for a significant portion of our revenues. A finding by the SBA that we no longer qualify to receive SBIR awards could adversely affect our business.

We compete as a small business for some of our government contracts. Our revenues derived from the SBIR program account for a significant portion of our consolidated total revenues, and contract research, including SBIR contracts, will remain a significant portion of our consolidated total revenues for the foreseeable future. For the nine months ended September 30, 2017 and 2016, revenues generated under the SBIR program represented 32% and 35%, respectively, of our total revenues.

We may not continue to qualify to participate in the SBIR program or to receive new SBIR awards from federal agencies. In order to qualify for SBIR contracts and grants, we must meet certain size and ownership eligibility criteria. These eligibility criteria are applied as of the time of the award of a contract or grant. A company can be declared ineligible for a contract award as a result of a size challenge filed with the SBA by a competitor or a federal agency.

In order to be eligible for SBIR contracts and grants, under current SBA rules we must be more than 50% owned and controlled by individuals who are U.S. citizens or permanent resident aliens, and/or other small business concerns (each of which is more than 50% owned and controlled by individuals who are U.S. citizens or permanent resident aliens) or certain qualified investment companies. In the event our institutional ownership significantly increases, either because of increased buying by institutions or selling by individuals, we could lose eligibility for new SBIR contracts and grants.

Also, in order to be eligible for SBIR contracts and grants, the number of our employees, including those of any entities that are considered to be affiliated with us, cannot exceed 500. As of September 30, 2017, we had approximately 190 full-time employees. In determining whether we are affiliated with any other entity, the SBA may analyze whether another entity controls or has the power to control us. Carilion Clinic is our largest institutional stockholder. Since early 2011, a formal size determination by the SBA that focused on whether or not Carilion is or was our affiliate has been outstanding. Although we do not believe that Carilion has or had the power to control our company, we cannot assure you that the SBA will interpret its regulations in our favor on this question. If the SBA were to make a determination that we are or were affiliated with Carilion, we would exceed the size limitations, as Carilion has over 500 employees. In that case, we would lose eligibility for new SBIR contracts and grants and other awards that are set aside for small businesses based on the criterion of number of employees, and the relevant government agency would have the discretion to suspend performance on existing SBIR grants. The loss of our eligibility to receive SBIR awards would have a material adverse impact on our revenues, cash flows and our ability to fund our growth.

Moreover, as our business grows, it is foreseeable that we will eventually exceed the SBIR size limitations, in which case we may be required to seek alternative sources of revenues or capital.

A decline in government research contract awards or government funding for existing or future government research contracts, including SBIR contracts, could adversely affect our revenues, cash flows and ability to fund our growth. Technology Development segment revenues, which consist primarily of government-funded research, accounted for 41% and 39% of our consolidated total revenues for the nine months ended September 30, 2017 and 2016, respectively. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our research contracts and subcontracts were to be simultaneously delayed or canceled for budgetary, performance or other reasons. For example, the U.S. government may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S. government research contracts and subcontracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we, together with any affiliates, must continue to meet size and revenue limitations established by the U.S. government.

Our contract research customer base includes government agencies, corporations and academic institutions. Our customers are not obligated to extend their agreements with us and may elect not to do so. Also, our customers' priorities regarding funding for certain projects may change and funding resources may no longer be available at previous levels.

In addition, the Budget Control Act commits the U.S. government to reduce the federal deficit by \$1.2 trillion over ten years through a combination of automatic, across-the-board spending cuts and caps on discretionary spending. This "sequestration" under the Budget Control Act, which is split equally between defense and non-defense programs, went into effect on March 1, 2013. Any spending cuts required by "sequestration" could have a material adverse effect on our Technology Development revenues and, consequently, our results of operations. While the exact manner in which this

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“sequestration” may impact our business remains unclear, funding for programs in which we participate could be reduced, delayed or canceled. Our ability to obtain new contract awards also could be negatively affected. In addition to contract cancellations and changes in agency budgets, our future financial results may be adversely affected by curtailment of or restrictions on the U.S. government’s use of contract research providers, including curtailment due to government budget reductions and related fiscal matters or any legislation or resolution limiting the number or amount of awards we may receive. These or other factors could cause U.S. defense and other federal agencies to conduct research internally rather than through commercial research organizations or direct awards to other organizations, to reduce their overall contract research requirements or to exercise their rights to terminate contracts. Alternatively, the U.S. government may discontinue the SBIR program or its funding altogether. Also, SBIR regulations permit increased competition for SBIR awards from companies that may not have previously been eligible, such as those backed by venture capital operating companies, hedge funds and private equity firms. Any of these developments could limit our ability to obtain new contract awards and adversely affect our revenues, cash flows and ability to fund our growth.

Our narrowed scope and focus may make it more difficult for us to achieve or maintain operating profitability. Through the recent sale of our HSOR business to a third party, we have reduced our overall size and narrowed our focus. Although we anticipate realizing cost savings as a result of the sale of the HSOR operations, we will continue to incur significant operating expenses associated with our public company infrastructure. Accordingly, we will need to significantly increase the revenue we generate from our remaining operations in order to achieve or maintain operating profitability. While we intend to use a portion of the proceeds from the sale of the HSOR business to invest in our fiber optic sensing business, there can be no guarantee that these efforts will result in increased revenues sufficient to achieve or maintain profitability.

Our failure to attract, train and retain skilled employees or members of our senior management and to obtain necessary security clearances for such persons or maintain a facility security clearance would adversely affect our business and operating results.

The availability of highly trained and skilled technical and professional personnel is critical to our future growth and profitability. Competition for scientists, engineers, technicians and professional personnel is intense and our competitors aggressively recruit key employees. In the past, we have experienced difficulties in recruiting and hiring these personnel as a result of the tight labor market in certain fields. Any difficulty in hiring or retaining qualified employees, combined with our growth strategy and future needs for additional experienced personnel, particularly in highly specialized areas such as nanomaterial manufacturing and fiber optic sensing technologies, may make it more difficult to meet all of our needs for these employees in a timely manner. Although we intend to continue to devote significant resources to recruit, train and retain qualified employees, we may not be able to attract and retain these employees, especially in technical fields in which the supply of experienced qualified candidates is limited, or at the senior management level. Any failure to do so would have an adverse effect on our business. Any loss of key personnel could have a material adverse effect on our ability to meet key operational objectives, such as timely and effective project milestones and product introductions, which in turn could adversely affect our business, results of operations and financial condition.

We provide certain services to the U.S. government that require us to maintain a facility security clearance and for certain of our employees and our board chairman to hold security clearances. In general, the failure for necessary persons to obtain or retain sufficient security clearances, any loss by us of a facility security clearance or any public reprimand related to security matters could result in a U.S. government customer terminating an existing contract or choosing not to renew a contract or prevent us from bidding on or winning certain new government contracts.

In addition, our future success depends in a large part upon the continued service of key members of our senior management team. We do not maintain any key-person life insurance policies on our officers. The loss of any members of our management team or other key personnel could seriously harm our business.

Our business is subject to the cyclical nature of the markets in which we compete and any future downturn may reduce demand for our products and revenue.

Many factors beyond our control affect our business, including consumer confidence in the economy, interest rates, fuel prices and the general availability of credit. The overall economic climate and changes in Gross National Product

growth have a direct impact on some of our customers and the demand for our products. We cannot be sure that our business will not be adversely affected as a result of an industry or general economic downturn.

Our customers may reduce capital expenditures and have difficulty satisfying liquidity needs because of continued turbulence in the U.S. and global economies, resulting in reduced sales of our products and harm to our financial condition and results of operations.

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In particular, our historical results of operations have been subject to substantial fluctuations, and we may experience substantial period-to-period fluctuations in future results of operations. Any future downturn in the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in revenue or increase the volatility of the price of our common stock. Our revenue and results of operations may be adversely affected in the future due to changes in demand from customers or cyclical changes in the markets utilizing our products.

In addition, the telecommunications industry has, from time to time, experienced, and may again experience, a pronounced downturn. To respond to a downturn, many service providers may slow their capital expenditures, cancel or delay new developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from original equipment manufacturers, which would have a negative impact on our business. Weakness in the global economy or a future downturn in the telecommunications industry may cause our results of operations to fluctuate from quarter-to-quarter and year-to-year, harm our business, and may increase the volatility of the price of our common stock.

Customer acceptance of our products is dependent on our ability to meet changing requirements, and any decrease in acceptance could adversely affect our revenue.

Customer acceptance of our products is significantly dependent on our ability to offer products that meet the changing requirements of our customers, including telecommunication, military, medical and industrial corporations, as well as government agencies. Any decrease in the level of customer acceptance of our products could harm our business.

Our products must meet exacting specifications, and defects and failures may occur, which may cause customers to return or stop buying our products.

Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. However, our products are highly complex and may contain defects and failures when they are first introduced or as new versions are released. Our products are also subject to rough environments as they are integrated into our customer products for use by the end customers. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments, product returns or discounts, diversion of management resources or damage to our reputation and brand equity, and in some cases consequential damages, any of which would harm our operating results. In addition, delays in our ability to fill product orders as a result of quality control issues may negatively impact our relationship with our customers. We cannot assure you that we will have sufficient resources, including any available insurance, to satisfy any asserted claims.

Rapidly changing standards and regulations could make our products obsolete, which would cause our revenue and results of operations to suffer.

We design products to conform to our customers' requirements and our customers' systems may be subject to regulations established by governments or industry standards bodies worldwide. Because some of our products are designed to conform to current specific industry standards, if competing or new standards emerge that are preferred by our customers, we would have to make significant expenditures to develop new products. If our customers adopt new or competing industry standards with which our products are not compatible, or the industry groups adopt standards or governments issue regulations with which our products are not compatible, our existing products would become less desirable to our customers and our revenue and results of operations would suffer.

The markets for many of our products are characterized by changing technology which could cause obsolescence of our products, and we may incur substantial costs in delivering new products.

The markets for many of our products are characterized by changing technology, new product introductions and product enhancements, and evolving industry standards. The introduction or enhancement of products embodying new technology or the emergence of new industry standards could render existing products obsolete, and result in a write down to the value of our inventory, or result in shortened product life cycles. Accordingly, our ability to compete is in part dependent on our ability to continually offer enhanced and improved products.

The success of our new product offerings will depend upon several factors, including our ability to:

- accurately anticipate customer needs;

•innovate and develop new technologies and applications;
•successfully commercialize new technologies in a timely manner;
•price products competitively and manufacture and deliver products in sufficient volumes and on time; and

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differentiate our product offerings from those of our competitors.

Some of our products are used by our customers to develop, test and manufacture their products. We therefore must anticipate industry trends and develop products in advance of the commercialization of our customers' products. In developing any new product, we may be required to make a substantial investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers' needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

Our inability to find new customers or retain existing customers could harm our business.

Our business is reliant on our ability to find new customers and retain existing customers. In particular, customers normally purchase certain of our products and incorporate them into products that they, in turn, sell in their own markets on an ongoing basis. As a result, the historical sales of these products have been dependent upon the success of our customers' products and the future performance of our business is dependent upon our success in finding new customers and receiving new orders from existing customers.

In several markets, the quality and reliability of our products are a major concern for our customers, not only upon the initial manufacture of the product, but for the life of the product. Many of our products are used in remote locations for higher value assembly, making servicing of our products unfeasible. Any failure of the quality or reliability of our products could harm our business.

If our customers do not qualify our products or if their customers do not qualify their products, our results of operations may suffer.

Most of our customers do not purchase our optoelectronics products prior to qualification of the products and satisfactory completion of factory audits and vendor evaluation. Our existing products, as well as each new product, must pass through varying levels of qualification with our customers. In addition, because of the rapid technological changes in some markets, a customer may cancel or modify a design project before we begin large-scale manufacturing and receiving revenues from the customer. It is unlikely that we would be able to recover the expenses for cancelled or unutilized custom design projects. It is difficult to predict with any certainty whether our customers will delay or terminate product qualification or the frequency with which customers will cancel or modify their projects. Any such delay, cancellation or modification could have a negative effect on our results of operations. In addition, once a customer qualifies a particular supplier's product or component, these potential customers design the product into their system, which is known as a design-in win. Suppliers whose products or components are not designed in are unlikely to make sales to that customer until at least the adoption of a future redesigned system. Even then, many customers may be reluctant to incorporate entirely new products into their new systems, as doing so could involve significant additional redesign efforts and increased costs. If we fail to achieve design-in wins in potential customers' qualification processes, we will likely lose the opportunity for significant sales to those customers for a lengthy period of time.

If the end user customers that purchase systems from our customers fail to qualify or delay qualifications of any products sold by our customers that contain our products, our business could be harmed. The qualification and field testing of our customers' systems by end user customers is long and unpredictable. This process is not under our control or that of our customers and, as a result, the timing of our sales may be unpredictable. Any unanticipated delay in qualification of one of our customers' products could result in the delay or cancellation of orders from our customers for products included in their equipment, which could harm our results of operations.

Customer demand for our products is difficult to accurately forecast and, as a result, we may be unable to optimally match production with customer demand, which could adversely affect our business and financial results.

We make planning and spending decisions, including determining the levels of business that we will seek and accept, production schedules, inventory levels, component procurement commitments, personnel needs and other resource requirements, based on our estimates of customer requirements. The short-term nature of commitments by many of our customers and the possibility of unexpected changes in demand for their products reduce our ability to accurately estimate future customer requirements. On occasion, customers may require rapid increases in production, which can strain our resources, cause our manufacturing to be negatively impacted by materials shortages, necessitate higher or more restrictive procurement commitments, increase our manufacturing yield loss and scrapping of excess materials,

and reduce our gross margin. We may not have sufficient capacity at any given time to meet the volume demands of our customers, or one or more of our suppliers may not have sufficient capacity at any given time to meet our volume demands. Conversely, a downturn in the markets in which our customers compete can cause, and in the past have caused, our customers to significantly reduce or delay

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the amount of products ordered or to cancel existing orders, leading to lower utilization of our facilities. Because many of our costs and operating expenses are relatively fixed, reduction in customer demand due to market downturns or other reasons would have a negative effect on our gross margin, operating income and cash flow.

Customer orders and forecasts are subject to cancellation or modification at any time which could result in higher manufacturing costs.

Our sales are made primarily pursuant to standard purchase orders for delivery of products. However, by industry practice, some orders may be canceled or modified at any time. When a customer cancels an order, they are responsible for all finished goods, all costs, direct and indirect, incurred by us, as well as a reasonable allowance for anticipated profits. No assurance can be given that we will receive these amounts after cancellation. Furthermore, uncertainty in customer forecasts of their demands and other factors may lead to delays and disruptions in manufacturing, which could result in delays in product shipments to customers and could adversely affect our business.

Fluctuations and changes in customer demand are common in our business. Such fluctuations, as well as quality control problems experienced in manufacturing operations, may cause delays and disruptions in our manufacturing process and overall operations and reduce output capacity. As a result, product shipments could be delayed beyond the shipment schedules requested by our customers or could be canceled, which would negatively affect our sales, operating income, strategic position at customers, market share and reputation. In addition, disruptions, delays or cancellations could cause inefficient production which in turn could result in higher manufacturing costs, lower yields and potential excess and obsolete inventory or manufacturing equipment. In the past, we have experienced such delays, disruptions and cancellations.

The results of our operations could be adversely affected by economic and political conditions and the effects of these conditions on our customers' businesses and levels of business activity.

Global economic and political conditions affect our customers' businesses and the markets they serve. A severe or prolonged economic downturn or a negative or uncertain political climate could adversely affect our customers' financial conditions and the timing or levels of business activity of our customers and the industries we serve. This may reduce the demand for our products or depress pricing for our products and have a material adverse effect on our results of operations. Changes in global economic conditions could also shift demand to products or services for which we do not have competitive advantages, and this could negatively affect the amount of business we are able to obtain. In addition, if we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, and our business could be negatively affected as a result. We have a history of losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses and may never achieve or maintain profitability or positive cash flow.

We realized a net loss from continuing operations of \$0.3 million and \$3.0 million for the nine months ended September 30, 2017 and 2016, respectively. We expect to continue to incur significant expenses as we pursue our strategic initiatives, including increased expenses for research and development, sales and marketing and manufacturing. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur greater than anticipated transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we may incur net losses for the foreseeable future, and these losses could be substantial. At a certain level, continued net losses could impair our ability to comply with NASDAQ continued listing standards, as described further below.

We have obtained capital by borrowing money under term loans and we might require additional capital to support and expand our business; our term loan has various loan covenants with which we must comply.

We intend to continue to make investments to support our business growth, including developing new products, enhancing our existing products, obtaining important regulatory approvals, enhancing our operating infrastructure, completing our development activities and building our commercial scale manufacturing facilities. To the extent that we are unable to become or remain profitable and to finance our activities from continuing operations, we may require additional funds to support these initiatives and to grow our business.

If we are successful in raising additional funds through issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, including as the result of the issuance of warrants in connection with the

financing, and any new equity securities we issue could have rights, preferences and privileges superior to those of our existing common stock. Furthermore, such financings may jeopardize our ability to apply for SBIR grants or qualify for SBIR contracts or grants, and our dependence on SBIR grants may restrict our ability to raise additional outside capital. If we raise additional

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funds through debt financings, these financings may involve significant cash payment obligations and covenants that restrict our ability to operate our business and make distributions to our stockholders.

We have term loans with Silicon Valley Bank ("SVB"), which requires us to observe certain financial and operational covenants, including maintenance of a minimum cash balance of \$4.0 million, protection and registration of intellectual property rights, and certain customary negative covenants, as well as other customary events of default. If any event of default occurs SVB may declare due immediately all borrowings under our term loans and foreclose on the collateral. Furthermore, an event of default would result in an increase in the interest rate on any amounts outstanding.

If we are unable to obtain adequate financing or financing terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

Our nanotechnology-enabled products are new and may be, or may be perceived as being, harmful to human health or the environment.

While we believe that none of our current products contain chemicals known by us to be hazardous or subject to environmental regulation, it is possible that our current or future products, particularly carbon-based nanomaterials, may become subject to environmental or other regulation. We intend to develop and sell carbon-based nanomaterials as well as nanotechnology-enabled products, which are products that include nanomaterials as a component to enhance those products' performance. Nanomaterials and nanotechnology-enabled products have a limited historical safety record. Because of their size or shape or because they may contain harmful elements, such as gadolinium and other rare-earth metals, our products could pose a safety risk to human health or the environment. These characteristics may also cause countries to adopt regulations in the future prohibiting or limiting the manufacture, distribution or use of nanomaterials or nanotechnology-enabled products. Such regulations may inhibit our ability to sell some products containing those materials and thereby harm our business or impair our ability to develop commercially viable products.

The subject of nanotechnology has received negative publicity and has aroused public debate. Government authorities could, for social or other purposes, prohibit or regulate the use of nanotechnology. Ethical and other concerns about nanotechnology could adversely affect acceptance of our potential products or lead to government regulation of nanotechnology-enabled products.

We face and will face substantial competition in several different markets that may adversely affect our results of operations.

We face and will face substantial competition from a variety of companies in several different markets. As we focus on developing marketing and selling fiber optic sensing products, we may also face substantial and entrenched competition in that market.

Many of our competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we do. These competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. In addition, current and potential competitors have established or may establish financial or strategic relationships among themselves or with existing or potential customers or other third parties. Accordingly, new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or new competitors, in which case our revenues may fail to increase or may decline.

Intense competition in our markets could result in aggressive business tactics by our competitors, including aggressively pricing their products or selling older inventory at a discount. If our current or future competitors utilize aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our sales prices.

Decreases in average selling prices of our products may increase operating losses and net losses, particularly if we are not able to reduce expenses commensurately.

The market for optical components and subsystems continues to be characterized by declining average selling prices resulting from factors such as increased price competition among optical component and subsystem manufacturers, excess capacity, the introduction of new products and increased unit volumes as manufacturers continue to deploy

network and storage systems. In recent years, we have observed a significant decline of average selling prices, primarily in the telecommunications market. We anticipate that average selling prices will continue to decrease in the future in response to product introductions by competitors or by us, or in response to other factors, including price pressures from significant customers. In order to sustain profitable operations, we must, therefore, reduce the cost of our current designs or continue to develop and introduce new

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products on a timely basis that incorporate features that can be sold at higher average selling prices. Failure to do so could cause our sales to decline and operating losses to increase.

Our cost reduction efforts may not keep pace with competitive pricing pressures. To remain competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in redesigning our products or delivering our products to market in a timely manner. We cannot assure you that any redesign will result in sufficient cost reductions enabling us to reduce the price of our products to remain competitive or positively contribute to operating results.

Shifts in product mix may result in declines in gross profit.

Our gross profit margins vary among our product platforms, and are generally highest on our test & measurement instruments. Our overall gross profit may fluctuate from period to period as a result of a variety of factors including shifts in product mix, the introduction of new products, and decreases in average selling prices for older products. If our customers decide to buy more of our products with low gross profit margins or fewer of our products with high gross profit margins, our total gross profits could be harmed.

Risks Relating to our Operations and Business Strategy

If we cannot successfully transition our revenue mix from contract research revenues to product sales and license revenues, we may not be able to fully execute our business model or grow our business.

Our business model and future growth depend on our ability to transition to a revenue mix that contains significantly larger product sales and revenues from the provision of services or from licensing. Product sales and these revenues potentially offer greater scalability than contract research revenues. Our current plan is to increase our sales of commercial products, our licensing revenues and our provision of non-research services to customers so as to represent a larger percentage of our total revenues. If we are unable to develop and grow our product sales and revenues from the provision of services or from licensing to augment our contract research revenues, however, our ability to execute our business model or grow our business could suffer. There can be no assurance that we will be able to achieve increased revenues in this manner.

Failure to develop, introduce and sell new products or failure to develop and implement new technologies, could adversely impact our financial results.

Our success will depend on our ability to develop and introduce new products that customers choose to buy. The new products the market requires tend to be increasingly complex, incorporating more functions and operating at faster speeds than old products. If we fail to introduce new product designs or technologies in a timely manner or if customers do not successfully introduce new systems or products incorporating our products, our business, financial condition and results of operations could be materially harmed.

If we are unable to manage growth effectively, our revenues and net loss could be adversely affected.

We may need to expand our personnel resources to grow our business effectively. We believe that sustained growth at a higher rate will place a strain on our management as well as on our other human resources. To manage this growth, we must continue to attract and retain qualified management, professional, scientific and technical and operating personnel. If we are unable to recruit a sufficient number of qualified personnel, we may be unable to staff and manage projects adequately, which in turn may slow the rate of growth of our contract research revenues or our product development efforts.

We may not be successful in identifying market needs for new technologies or in developing new products.

Part of our business model depends on our ability to correctly identify market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so in part because our contract research largely centers on identification and development of unproven technologies, often for new or emerging markets.

Furthermore, we must identify the most promising technologies from a sizable pool of projects. If our commercialization strategy process fails to identify projects with commercial potential or if management does not ensure that such projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we also develop successful commercial products to address market needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development are technologically innovative and require significant and lengthy product development efforts. These

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include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers' requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues. We face risks associated with our international business.

We currently conduct business internationally and we might considerably expand our international activities in the future. Our international business operations are subject to a variety of risks associated with conducting business internationally, including:

- having to comply with U.S. export control regulations and policies that restrict our ability to communicate with non-U.S. employees and supply foreign affiliates and customers;
- changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, perform services or repatriate profits to the United States;
- the imposition of tariffs;
- hyperinflation or economic or political instability in foreign countries;
- imposition of limitations on, or increase of withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;
- conducting business in places where business practices and customs are unfamiliar and unknown;
- the imposition of restrictive trade policies;
- the imposition of inconsistent laws or regulations;
- the imposition or increase of investment and other restrictions or requirements by foreign governments;
- uncertainties relating to foreign laws and legal proceedings;
- having to comply with a variety of U.S. laws, including the Foreign Corrupt Practices Act ("FCPA"); and
- having to comply with licensing requirements.

We do not know the impact that these regulatory, geopolitical and other factors may have on our international business in the future.

We may dispose of or discontinue existing product lines and technology developments, which may adversely impact our future results.

On an ongoing basis, we evaluate our various product offerings and technology developments in order to determine whether any should be discontinued or, to the extent possible, divested. For example, we recently sold our HSOR business to a third party. In addition, if we are unable to generate the amount of cash needed to fund the future operations of our business, we may be forced to sell one or more of our product lines or technology developments. We cannot guarantee that we have correctly forecasted, or that we will correctly forecast in the future, the right product lines and technology developments to dispose or discontinue or that our decision to dispose of or discontinue various investments, products lines and technology developments is prudent if market conditions change. In addition, there are no assurances that the discontinuance of various product lines will reduce operating expenses or will not cause us to incur material charges associated with such decision. Furthermore, the discontinuance of existing product lines entails various risks, including the risk that we will not be able to find a purchaser for a product line or the purchase price obtained will not be equal to at least the book value of the net assets for the product line. Other risks include managing the expectations of, and maintaining good relations with, our historical customers who previously purchased products from a disposed or discontinued product line, which could prevent us from selling other products

to them in the future. We may also incur other significant liabilities and costs associated with disposal or discontinuance of product lines, including employee severance costs and excess facilities costs.

We may be liable for damages based on product liability claims relating to defects in our products, which might be brought against us directly, or against our customers in their end-use markets. Such claims could result in a loss of customers in addition to substantial liability in damages.

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Our products are complex and undergo quality testing as well as formal qualification, both by our customers and by us. However, defects may occur from time to time. Our customers' testing procedures may be limited to evaluating our products under likely and foreseeable failure scenarios and over varying amounts of time. For various reasons, such as the occurrence of performance problems that are unforeseeable in testing or that are detected only when products age or are operated under peak stress conditions, our products may fail to perform as expected long after customer acceptance. Failures could result from faulty components or design, problems in manufacturing or other unforeseen reasons. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty in order to maintain customer relationships. Any significant product failure could result in lost future sales of the affected product and other products, as well as customer relations problems, litigation and damage to our reputation.

In addition, many of our products are embedded in, or deployed in conjunction with, our customers' products, which incorporate a variety of components, modules and subsystems and may be expected to interoperate with modules produced by third parties. As a result, not all defects are immediately detectable, and, when problems occur, it may be difficult to identify the source of the problem. These problems may cause us to incur significant damages or warranty and repair costs, divert the attention of our engineering personnel from internal product development efforts and cause significant customer relations problems or loss of customers, all of which would harm our business.

Furthermore, many of our products may provide critical performance attributes to our customers' products that will be sold to end users who could potentially bring product liability suits in which we could be named as a defendant. The sale of these products involves the risk of product liability claims. If a person were to bring a product liability suit against one of our customers, this customer may attempt to seek contribution from us. A person may also bring a product liability claim directly against us. A successful product liability claim or series of claims against us in excess of our insurance coverage for payments, for which w