ILLUMINA INC
Form 10-Q
October 29, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For Quarterly Period Ended September 28, 2008

o **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 000-30361
Illumina, Inc.
(Exact name of registrant as specified in its charter)

Delaware	33-0804655
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9885 Towne Centre Drive, San Diego, CA	92121
(Address of Principal Executive Offices)	(Zip Code)

(858) 202-4500
(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 þ No o

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

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

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

As of October 17, 2008, there were 123,738,333 shares of the Registrant s Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Illumina, Inc.
Condensed Consolidated Balance Sheets
(In thousands)

	September 28, 2008 (Unaudited)	December 30, 2007 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 355,219	$ 174,941
Short-term investments	294,428	211,141
Accounts receivable, net	124,161	83,119
Inventory, net	72,953	53,980
Deferred tax assets, current portion	20,041	26,934
Prepaid expenses and other current assets	8,424	12,640
Total current assets	875,226	562,755
Property and equipment, net	82,198	46,274
Long-term investments	51,567	
Goodwill	228,734	228,734
Intangible assets, net	50,299	58,116
Deferred tax assets, long-term portion	61,364	80,245
Other assets, net	11,934	11,608
Total assets	$ 1,361,322	$ 987,732
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 91,220	$ 75,163
Litigation settlements payable		90,536
Current portion of long-term debt	400,127	16
Total current liabilities	491,347	165,715
Long-term debt, less current portion	460	400,000
Other long-term liabilities	16,522	10,339
Commitments and contingencies		
Stockholders equity	852,993	411,678
Total liabilities and stockholders equity	$ 1,361,322	$ 987,732

(1) The Condensed Consolidated Balance Sheet at December 30, 2007 has been derived from the

audited financial
statements as of
that date.

See accompanying notes to the condensed consolidated financial statements.

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Illumina, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Revenue:				
Product revenue	$ 140,319	$ 90,021	$ 379,554	$ 225,583
Service and other revenue	9,941	7,489	32,744	28,611
Total revenue	150,260	97,510	412,298	254,194
Costs and expenses:				
Cost of product revenue (excluding impairment of manufacturing equipment and amortization of intangible assets)	51,088	34,582	140,761	83,436
Cost of service and other revenue	3,342	2,496	10,209	8,903
Research and development	27,567	19,753	71,625	53,893
Selling, general and administrative	39,365	24,307	108,808	71,237
Impairment of manufacturing equipment			4,069	
Amortization of intangible assets	2,702	662	7,785	1,767
Acquired in-process research and development	24,660		24,660	303,400
Total costs and expenses	148,724	81,800	367,917	522,636
Income (loss) from operations	1,536	15,710	44,381	(268,442)
Interest and other income, net	2,446	3,978	6,856	9,043
Income (loss) before income taxes	3,982	19,688	51,237	(259,399)
Provision for income taxes	11,270	5,185	29,699	14,912
Net income (loss)	$ (7,288)	$ 14,503	$ 21,538	$ (274,311)
Net income (loss) per basic share*	$ (0.06)	$ 0.13	$ 0.19	$ (2.55)
Net income (loss) per diluted share*	$ (0.06)	$ 0.12	$ 0.16	$ (2.55)
Shares used in calculating basic net income (loss) per share*	119,733	108,636	114,991	107,694
Shares used in calculating diluted net income (loss) per share*	119,733	118,790	134,375	107,694

* Adjusted to reflect a

two-for-one
stock split
effective
September 22,
2008.

See accompanying notes to the condensed consolidated financial statements

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Illumina, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(In thousands)

	Nine Months Ended	
	September 28, 2008	**September 30, 2007**
Operating activities:		
Net income (loss)	$ 21,538	$ (274,311)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Acquired in-process research and development	24,660	303,400
Amortization of increase in inventory valuation		942
Amortization of intangible assets	7,785	1,803
Amortization of debt issuance costs	1,026	839
Depreciation expense	12,206	8,177
Loss on disposal of property and equipment	273	16
Impairment of manufacturing equipment	4,069	
Stock-based compensation expense	35,803	24,130
Deferred income taxes	25,764	
Amortization of gain on sale of land and building	(128)	(145)
Changes in operating assets and liabilities:		
Accounts receivable	(43,142)	(33,920)
Inventory	(18,230)	(17,151)
Prepaid expenses and other current assets	3,378	(890)
Other assets	(1,275)	1,674
Accounts payable and accrued liabilities	9,871	18,414
Litigation settlements payable	(90,536)	
Accrued income taxes	1,713	12,130
Other long-term liabilities	6,990	(667)
Net cash provided by operating activities	1,765	44,441
Investing activities:		
Cash (paid) obtained in acquisition, including cash paid for transaction costs	(24,666)	72,083
Purchases of available-for-sale securities	(430,851)	(449,088)
Sales and maturities of available-for-sale securities	290,629	256,239
Purchases of property and equipment	(45,139)	(15,257)
Proceeds from sale of fixed assets		40
Cash paid for intangible assets		(85)
Net cash used in investing activities	(210,027)	(136,068)
Financing activities:		
Payments on long-term debt	(15)	(86)
Proceeds from issuance of convertible debt, net of issuance costs		390,270
Purchase of convertible note hedges		(139,040)

Proceeds from the exercise of warrants	2,991	92,642
Common stock repurchases		(251,622)
Proceeds from secondary offering, net of issuance cost	342,637	
Proceeds from issuance of common stock	41,473	25,684
Net cash provided by financing activities	387,086	117,848
Effect of foreign currency translation on cash and cash equivalents	1,454	(500)
Net increase in cash and cash equivalents	180,278	25,721
Cash and cash equivalents at beginning of period	174,941	38,386
Cash and cash equivalents at end of period	$ 355,219	$ 64,107

See accompanying notes to the condensed consolidated financial statements.

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Illumina, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Summary of Significant Accounting Principles

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. In management s opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited financial statements should be read in conjunction with the Company s 2007 audited financial statements and footnotes included in the Company s Annual Report on Form 10-K for the year ended December 30, 2007, as filed with the Securities and Exchange Commission (SEC) on February 26, 2008.

The preparation of financial statements requires that management make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Fiscal Year

The Company s fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, and September 30. The three and nine months ended September 28, 2008 and September 30, 2007 were both 13 and 39 weeks, respectively.

Revenue Recognition

The Company s revenue is generated primarily from the sale of products and services. Product revenue consists of sales of arrays, reagents, flow cells, instrumentation, and oligonucleotides (oligos), which are short sequences of DNA. Service and other revenue consists of revenue received for performing genotyping and sequencing services, extended warranty sales and amounts earned under research agreements with government grants, which are recognized in the period during which the related costs are incurred.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable and collectibility is reasonably assured. In instances where final acceptance of the product or system is required, revenue is deferred until all the acceptance criteria have been met. All revenue is recorded net of any applicable allowances for returns or discounts.

Revenue for product sales is recognized generally upon shipment and transfer of title to the customer, provided no significant obligations remain and collection of the receivables is reasonably assured. Revenue from the sale of instrumentation is recognized when earned, which is generally upon shipment. Revenue for genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping and sequencing analysis data is delivered to the customer.

In order to assess whether the price is fixed and determinable, the Company ensures there are no refund rights. If payment terms are based on future performance, the Company defers revenue recognition until the price becomes fixed and determinable. The Company assesses collectibility based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If the Company determines that collection of a payment is not reasonably assured, revenue recognition is deferred until the time collection becomes reasonably assured, which is generally upon receipt of payment.

Sales of instrumentation generally include a standard one-year warranty. The Company also sells separately priced maintenance (extended warranty) contracts, which are generally for one or two years, upon the expiration of the initial warranty. Revenue for extended warranty sales is recognized ratably over the term of the extended warranty period. Reserves are provided for estimated product warranty expenses at the time the associated revenue is recognized. If the Company were to experience an increase in warranty claims or if costs of servicing its warrantied products were greater than its estimates, gross margins could be adversely affected.

While the majority of its sales agreements contain standard terms and conditions, the Company does enter into agreements that contain multiple elements or non-standard terms and conditions. Emerging Issues Task Force (EITF) No. 00-21, *Revenue Arrangements with Multiple Deliverables,* provides guidance on accounting for arrangements that involve the delivery or performance of multiple products, services, or rights to use assets within contractually binding arrangements. For arrangements with multiple elements, revenue recognition is based on the individual units of accounting determined to exist in the arrangement. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis and there is objective and reliable evidence of the fair value of the undelivered items. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. The fair value of an item is generally the price charged for the product, if the item is regularly sold on a stand-alone basis. When objective and reliable evidence of fair value exists for all units of accounting in an arrangement, the arrangement consideration is generally allocated to each unit of accounting based upon its relative fair value. In those instances when objective and reliable evidence of fair value exists for the undelivered items but not for the delivered items, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of arrangement consideration allocated to the delivered items equals the total arrangement consideration less the aggregate fair value of the undelivered items. When the Company is unable to establish stand-alone value for delivered items or when fair value of undelivered items has not been established, revenue is deferred until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements. The Company recognizes revenue for delivered elements only when it determines that the fair values of undelivered elements are known and there are no uncertainties regarding customer acceptance.

Impairment of Long-lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if indicators of impairment exist, the Company assesses the recoverability of the affected long-lived assets by determining whether the carrying value of such assets can be recovered through undiscounted future operating cash flows. If impairment is indicated, the Company measures the future discounted cash flows associated with the use of the asset and adjusts the value of the asset accordingly. Factors that would necessitate an impairment assessment include a significant decline in the Company s stock price and market capitalization compared to its net book value, significant changes in the ability of a particular asset to generate positive cash flows and significant changes in the Company s strategic business objectives and utilization of the asset.

Stock-Based Compensation

The Company uses the Black-Scholes-Merton option-pricing model to determine the fair value of stock-based awards under SFAS No. 123(R), *Share-Based Payment*. This model incorporates various assumptions including volatility, expected life and interest rates. For the three and nine months ended September 28, 2008, volatility was determined by equally weighing the historical and implied volatility of the Company s common stock. The historical volatility of the Company s common stock over the most recent period is generally commensurate with the estimated expected life of the Company s stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur and other relevant factors. The implied volatility is calculated from the implied market volatility of exchange-traded call options on the Company s common stock. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

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The assumptions used for the specified reporting periods and the resulting estimates of weighted-average fair value per share of options granted and for stock purchases under the Employee Stock Purchase Plan (ESPP) during those periods are as follows:

	Three Months Ended		Nine Months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Interest rate stock options	3.27 - 3.36%	4.47 - 4.90%	2.85 - 3.52%	4.61 - 4.90%
Interest rate stock purchases	2.90 - 4.47%	4.71 - 4.83%	2.90 - 4.71%	4.71 - 4.86%
Volatility stock options	52-53%	55-58%	51-56%	55-70%
Volatility stock purchases	56-58%	69 - 75%	56 - 69%	69 - 76%
Expected life stock options	6 years	6 years	6 years	6 years
Expected life stock purchases	6 - 12 months	6 -12 months	6 - 12 months	6 - 12 months
Expected dividend yield	0%	0%	0%	0%
Weighted average fair value per share of options granted	$ 22.60	$ 12.96	$ 18.75	$ 12.54
Weighted average fair value per share of employee stock purchases	$ 8.88	$ 7.33	$ 8.13	$ 6.67

As of September 28, 2008, approximately $153.3 million of total unrecognized compensation cost related to stock options, restricted stock and ESPP shares issued to date is expected to be recognized over a weighted-average period of approximately 1.9 years.

Total share-based compensation expense for employee stock options and stock purchases for the three and nine months ended September 28, 2008 and September 30, 2007 is comprised of the following (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Cost of product revenue	$ 1,093	$ 1,059	$ 3,734	$ 2,901
Cost of service and other revenue	109	60	288	197
Research and development	3,535	2,607	10,289	7,035
Selling, general and administrative	8,003	4,942	21,559	13,998
Share-based compensation expense before taxes	12,740	8,668	35,870	24,131
Related income tax benefits	(3,649)	(3,724)	(11,447)	(5,643)
Share-based compensation expense, net of taxes	$ 9,091	$ 4,944	$ 24,423	$ 18,488
Net share-based compensation expense per share of common stock:				
Basic	$ 0.08	$ 0.05	$ 0.21	$ 0.17
Diluted	$ 0.08	$ 0.04	$ 0.18	$ 0.17

Net Income (Loss) per Share

On July 22, 2008, the Company announced a two-for-one stock split in the form of a 100% stock dividend with a record date of September 10, 2008 and a distribution date of September 22, 2008. Share and per share amounts have been restated to reflect the stock split for all periods presented.

Basic and diluted net income (loss) per share of common stock is presented in conformity with SFAS No. 128, *Earnings per Share,* for all periods presented. In accordance with SFAS No. 128, basic net income (loss) per share is computed using the weighted-average number of shares of common stock outstanding during the period, less shares subject to repurchase. Diluted net income (loss) per share is computed using the weighted average number of common and dilutive common equivalent shares from the Company s Convertible Senior Notes, equity awards, warrants sold in connection with the Convertible Senior Notes and warrants assumed in the acquisition of Solexa, Inc. (Solexa) using the treasury stock method. The following table presents the calculation of weighted-average shares used to calculate basic and diluted net income (loss) per share (in thousands):

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	Three Months Ended		Nine Months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Weighted-average shares outstanding	119,733	108,672	114,991	107,728
Less: Weighted-average shares of common stock subject to repurchase		(36)		(34)
Weighted-average shares used in calculating basic net income (loss) per share	119,733	108,636	114,991	107,694
Plus: Effect of dilutive Convertible Senior Notes		1,311	7,942	
Plus: Effect of dilutive equity awards		6,739	5,675	
Plus: Effect of dilutive warrants sold in connection with the Convertible Senior Notes			3,375	
Plus: Effect of dilutive warrants assumed in the acquisition of Solexa		2,104	2,392	
Weighted-average shares used in calculating diluted net income (loss) per share	119,733	118,790	134,375	107,694

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes foreign currency translation adjustments from prior periods for the foreign operations and unrealized gains and losses on the Company s available-for-sale securities, including a temporary impairment charge of $4.3 million as of September 28, 2008 associated with the Company s auction rate securities. Refer to Note 4 for further discussion regarding this unrealized loss.

The components of other comprehensive income (loss) are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Net (loss) income	$ (7,288)	$ 14,503	$ 21,538	$ (274,311)
Foreign currency translation adjustments		312	155	514
Unrealized gain (loss) on investments	(1,078)	428	(3,320)	(10,299)
Total other comprehensive (loss) income	$ (8,366)	$ 15,243	$ 18,373	$ (284,096)

Functional Currency

The Company has historically identified the local currency as the functional currency in each of its foreign subsidiaries and the effects of translation were recorded as other comprehensive income (loss). During the third quarter of 2008, the Company reorganized its international structure to execute a more efficient relationship between product development, product manufacturing and sales. The reorganization increased the foreign subsidiaries anticipated dependence on the U.S. entity for management decisions, financial support, production assets and inventory thereby making the foreign subsidiaries more of a direct and integral component of the U.S. entity s operations. As a result, the Company reassessed the primary economic environment of its foreign subsidiaries and determined the subsidiaries are more U.S. dollar based, resulting in a U.S. dollar functional currency determination. Currently, as a result of this change, the Company remeasures its foreign subsidiaries assets and liabilities and income and expense accounts related to nonmonetary assets and liabilities to the U.S. dollar and records the net gains or losses resulting from remeasurement in its consolidated statements of operations.

Reclassifications

Certain previously reported amounts have been reclassified to conform to the current period s presentation.

Recent Accounting Pronouncements

SFAS No. 141(R), *Business Combinations*, was issued in December of 2007. SFAS No. 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. SFAS No. 141(R) also provides guidance for recognizing and measuring the goodwill acquired in the business combination and sets forth what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance will become effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact, if any, the adoption of this pronouncement will have on the Company s consolidated financial statements.

In May 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Accounting Principles Board Opinions (APB) 14-1, *Accounting for Convertible Debt Instruments that May be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1 or the FSP) that significantly impacts the accounting for convertible debt. The FSP requires cash settled convertible debt, such as the Company s $400.0 million aggregate principal amount of convertible notes that are currently outstanding, to be bifurcated into debt and equity components and accounted for separately at issuance. The value assigned to the debt component would be the estimated fair value, as of the issuance date, of a similar bond without the conversion feature. The difference between the bond cash proceeds and this estimated fair value would be recorded as a debt discount and amortized to interest expense over the life of the bond, resulting in the recognition of interest expense on these securities at an effective rate more comparable to what the Company would have incurred had the Company issued nonconvertible debt with otherwise similar terms. The equity component of the convertible debt securities would be included in the paid-in-capital section of stockholders equity on the Company s consolidated balance sheets and the initial carrying values of these debt securities would be correspondingly reduced. Although FSP APB 14-1 has no impact on the Company s actual past or future cash flows, it requires the Company to record a significant amount of non-cash interest expense as the debt discount is amortized, which would result in a material adverse impact on the results of operations and on earnings per share. In addition, if the Company s convertible debt is redeemed or converted prior to maturity, any unamortized debt discount at the time of such redemption or conversion would result in a loss on extinguishment. The Company is currently evaluating the impact this FSP will have on its results of operations upon adoption. FSP APB 14-1 will become effective for fiscal years beginning after December 15, 2008 and require retrospective application.

In October 2008, the FASB issued FASB FSP SFAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. The FSP clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective upon issuance, including for prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application should be accounted for as a change in accounting estimate following the guidance in FASB Statement No. 154, *Accounting Changes and Error Corrections*. However, the disclosure provisions in Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application. The Company believes the impact of this pronouncement on the Company s consolidated financial statements to be immaterial.

2. Acquisition

Avantome, Inc.

On August 1, 2008, the Company completed its acquisition of Avantome, Inc. (Avantome), a privately held Delaware corporation. As consideration for the acquisition, the Company paid $25.8 million in cash, including transaction costs, and may pay up to an additional $35.0 million in contingent cash consideration based on the achievement of certain milestones. The Company assumed $1.1 million in net assets, and recorded a charge of $24.7 million for purchased in-process research and development (IPR&D) primarily associated with the development of Avantome s low-cost, long read-length sequencing technology. The amount allocated to IPR&D was expensed upon acquisition as it was determined that the underlying project had not reached technological feasibility and had no alternative future use. The Company has assessed the contingent consideration payable in accordance with the provisions of SFAS No. 141, *Business Combinations*, and EITF 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination.* Approximately $11.0 million of the contingent consideration will be recorded as compensation expense over a three-year period as this consideration is due to the former primary shareholders of Avantome contingent upon their employment with the Company for three years. The remaining contingent consideration of $24.0 million will be recorded as additional purchase price when certain milestones are achieved or the amount is determinable beyond a reasonable doubt.

The results of Avantome s operations have been included in the Company s consolidated financial statements since the acquisition date of August 1, 2008. Pro forma results of operations have not been presented because the effects of the acquisition were not material.

Solexa, Inc.

On January 26, 2007, the Company completed its acquisition of Solexa, a Delaware corporation, in a stock-for-stock merger transaction. The Company issued approximately 26.2 million shares of its common stock as consideration for this merger.

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The purchase price of the acquisition is as follows (in thousands):

Fair market value of securities issued	$ 527,067
Fair market value of change of control bonuses and related taxes	8,182
Transaction costs not included in Solexa net tangible assets acquired	8,138
Fair market value of vested stock options, warrants and restricted stock assumed	75,334
Total purchase price	$ 618,721

Based on the estimated fair values at the acquisition date, the Company allocated $303.4 million to IPR&D, $62.2 million to tangible assets acquired and liabilities assumed and $24.4 million to intangible assets. The remaining excess of the purchase price over the fair value of net assets acquired of $228.7 million was allocated to goodwill.

The results of Solexa s operations have been included in the Company s consolidated financial statements since the acquisition date of January 26, 2007. The following unaudited pro forma information shows the results of the Company s operations for the specified reporting periods as though the acquisition had occurred as of the beginning of that period (in thousands, except per share data):

	Nine Months Ended September 30, 2007
Revenue	$ 254,249
Net income	$ 21,436
Basic net income per share	$ 0.20
Diluted net income per share	$ 0.18

The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the actual results of operations had the acquisition taken place as of the beginning of the period presented, or the results that may occur in the future. The pro forma results exclude the $303.4 million non-cash acquired IPR&D charge recorded upon the closing of the acquisition during the first quarter of 2007.

3. Segment Information

During the first quarter of 2008, the Company reorganized its operating structure into a newly created Life Sciences Business Unit, which includes all products and services related to the research market, namely the BeadArray, BeadXpress and Sequencing product lines. The Company also created a Diagnostics Business Unit to focus on the emerging opportunity in molecular diagnostics. For the three and nine months ended September 28, 2008, the Company had limited activity related to the Diagnostics Business Unit and operating results were reported on an aggregate basis to the chief operating decision maker of the Company, the chief executive officer. In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company operated in one segment for the three and nine months ended September 28, 2008.

4. Cash and Cash Equivalents and Investments

Cash and cash equivalents are comprised of short-term, highly liquid investments with maturities of 90 days or less from the date of purchase. Investments are comprised of available-for-sale securities recorded at estimated fair value. Unrealized gains and losses associated with the Company s investments, if any, are reported in stockholders equity in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

As of September 28, 2008, the Company s excess cash balances were primarily invested in marketable debt securities, including treasury bills and commercial paper with strong credit ratings, corporate bonds and short maturity mutual funds providing similar financial returns. Additionally, the Company had $55.9 million in auction rate securities issued primarily by municipalities and universities. During the nine months ended September 28, 2008, the Company recorded an unrealized loss of $4.3 million due to the failure associated with the auctions of each of these securities, which has limited the Company s ability to liquidate its investment and fully recover the carrying value in the near term. The Company has determined this reduction in fair value to be temporary. This unrealized loss reduced the fair value of the Company s auction rate securities to $51.6 million. These securities are classified as long-term investments and the unrealized loss is included as a component of other comprehensive income within stockholders equity in the Company s consolidated balance sheet.

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The municipal auction rate securities held by the Company are rated by the following agencies: Fitch, Moody s and Standard & Poor s. All of the securities held by the Company are currently rated AAA, the highest rating. Although their credit ratings did not deteriorate, there was insufficient demand at auction for all of the high-grade auction rate securities held by the Company during the first quarter of 2008, causing them to be illiquid. During the second and third quarter of 2008, the credit market did not recover and the auction rate securities remained illiquid. In the event the Company needs to access the funds that are in an illiquid state, it may not be able to do so without a loss of principal until a future auction on these investments is successful, the securities are redeemed by the issuer or they mature. As a result, the Company has recorded an unrealized loss during the nine months ended September 28, 2008. This unrealized loss was determined in accordance with SFAS No. 157, *Fair Value Measurements*, which was adopted by the Company on January 1, 2008.

As a basis for considering market participant assumptions in fair value measurements, SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Due to the lack of actively traded market data, the value of these auction rate securities and resulting unrealized loss was determined using Level 3 hierarchical inputs. These inputs include management s assumptions of pricing by market participants, including assumptions about risk. In accordance with SFAS No. 157, the Company used the concepts of fair value based on estimated discounted future cash flows of interest income over a projected 5-year period reflective of the length of time until the Company s securities become liquid or potentially get repurchased. A discount rate of approximately 5% was utilized when preparing this model. The classification of these securities as long-term assets was deemed appropriate as the Company believes it may not be able to liquidate its investments without significant loss within the next year. The Company currently believes these securities are not permanently impaired, primarily due to the government guarantee of the underlying securities and the Company s ability to hold these securities for the foreseeable future. The Company s cash, cash equivalents and short-term investments total $649.6 million as of September 28, 2008. Based on the liquidity of these funds and the Company s projected cash flows from operations, the Company believes that the illiquidity on the auction rate security investments will not materially affect its ability to execute its current business plan.

5. Inventories

Inventories are stated at the lower of standard cost (which approximates actual cost) or market. Inventory includes raw materials and finished goods that may be used in the research and development process and such items are expensed as consumed or expired. Provisions for slow moving, excess and obsolete inventories are provided based on product life cycle and development plans, product expiration and quality issues, historical experience and inventory levels. The components of net inventories are as follows (in thousands):

	September 28, 2008	December 30, 2007
Raw materials	$ 31,849	$ 27,098
Work in process	31,890	20,321
Finished goods	9,214	6,561
Total inventory, net	$ 72,953	$ 53,980

6. Impairment of Manufacturing Equipment

During fiscal 2008, the Company implemented next-generation imaging and decoding systems to be used in manufacturing. These systems were developed to increase existing capacity and allow the Company to transition to the Infinium High-Density (HD) product line. As a result of this transition, the demand for products manufactured on the previous infrastructure was reduced and certain systems were no longer being utilized. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, a non-cash impairment charge of $4.1 million was recorded in the second quarter of fiscal 2008 for the excess machinery. This charge is included as a separate line item in the Company s consolidated statement of operations. There was no change to useful lives and related depreciation expense of the remaining assets as the Company believes these estimates are currently reflective of the period the assets will be used in operations.

7. Goodwill and Intangible Assets

The Company accounts for goodwill and intangible assets under SFAS No. 142, *Goodwill and Other Intangible Assets*. As such, goodwill and other indefinite-lived intangible assets are not amortized, but are subject to annual impairment reviews or more frequent reviews if events or circumstances indicate there may be impairment. The Company performed its annual impairment test of goodwill as of May 30, 2008 noting no impairment. No indicators have arisen since management s assessment on May 30, 2008 that would require further assessment.

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The Company s intangible assets are comprised primarily of acquired core technology and customer relationships from the acquisition of Solexa and licensed technology from the Affymetrix settlement entered into on January 9, 2008. As a result of this settlement, the Company agreed, without admitting liability, to make a one-time payment to Affymetrix of $90.0 million. In return, Affymetrix agreed to dismiss with prejudice all lawsuits it had brought against the Company, and the Company agreed to dismiss with prejudice its counterclaims in the relevant lawsuits. Affymetrix also agreed not to sue the Company or its affiliates or customers for making, using or selling any of the Company s current products, evolutions of those products or services related to those products. In addition, Affymetrix agreed that, for four years, it will not sue the Company for making, using or selling the Company s products or services that are based on future technology developments. The covenant not to sue covers all fields other than photolithography, the process by which Affymetrix manufactures its arrays and a field in which the Company does not operate.

Of the total $90.0 million payment made on January 25, 2008, $36.0 million was recorded as licensed technology and classified as an intangible asset. The remaining $54.0 million was charged to expense during the fourth quarter of 2007. This allocation was determined in accordance with SFAS No. 5, *Accounting for Contingencies*, and EITF 00-21 using the concepts of fair value based on the past and estimated future revenue streams related to the products covered by the patents previously under dispute. The value of the licensed technology is the benefit derived, calculated using estimated discounted cash flows and future revenue projections, from the perpetual covenant not to sue for damages related to the sale of the Company s current products. The Company utilized a discount rate of 9.25% when preparing this model. The effective life of the licensed technology extends through 2015, the final expiry date of all patents considered in valuing the intangible asset. The related amortization is based on the higher of the percentage of usage or the straight-line method. The percentage of usage was determined using actual and projected revenues generated from products covered by the patents previously under dispute. For the current quarter, the percentage of usage was higher than the straight-line method, resulting in an expense of $2.0 million and $5.8 million for the three and nine months ended September 28, 2008, respectively.

Acquired core technology and customer relationships are being amortized on a straight-line basis over their effective useful lives of 10 and three years, respectively. The amortization of the Company s intangible assets is excluded from cost of product revenue and is separately classified as amortization of intangible assets on the Company s consolidated statements of operations.

The following is a summary of the Company s amortizable intangible assets as of the respective balance sheet dates (in thousands):

	September 28, 2008			**December 30, 2007**		
	Gross Carrying Amount	**Accumulated Amortization**	**Intangibles, Net**	**Gross Carrying Amount**	**Accumulated Amortization**	**Intangibles, Net**
Licensed technology	$ 36,000	$ (5,798)	$ 30,202	$ 36,000	$	$ 36,000
Core technology	23,500	(3,916)	19,584	23,500	(2,154)	21,346
Customer relationships	900	(500)	400	900	(275)	625
License agreements	1,029	(916)	113	1,029	(884)	145
Total intangible assets, net	$ 61,429	$ (11,130)	$ 50,299	$ 61,429	$ (3,313)	$ 58,116

8. Warranties

The Company generally provides a one-year warranty on genotyping, gene expression systems and sequencing systems. At the time revenue is recognized, the Company establishes an accrual for estimated warranty expenses associated with system sales. This expense is recorded as a component of cost of product revenue. Estimated warranty expenses associated with extended maintenance contracts are recorded as a cost of revenue ratably over the term of the maintenance contract.

Changes in the Company s warranty liability during the specified reporting period are as follows (in thousands):

Balance at December 30, 2007	$ 3,716
Additions charged to cost of revenue	8,222
Repairs and replacements	(5,090)
Balance at September 28, 2008	$ 6,848

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9. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of the following (in thousands):

	September 28, 2008	December 30, 2007
Accounts payable	$ 31,035	$ 24,311
Compensation	22,231	17,410
Short-term deferred revenue	8,749	7,541
Taxes	6,903	8,298
Reserve for product warranties	6,848	3,716
Customer deposits	6,728	5,266
Accrued royalties	2,942	1,867
Legal and other professional fees	2,017	4,276
Other	3,767	2,478
Total accounts payable and accrued liabilities	$ 91,220	$ 75,163

10. Stockholders Equity

Common Stock

On July 22, 2008, the Company announced a two-for-one stock split in the form of a 100% stock dividend with a record date of September 10, 2008 and a distribution date of September 22, 2008. Share and per share amounts have been restated to reflect the stock split for all periods presented.

On August 12, 2008, a total of 8,050,000 shares were sold to the public at a public offering price of $43.75 per share, raising net proceeds to the Company of approximately $342.6 million, after deducting underwriting discounts and commissions and estimated offering expenses.

On September 28, 2008, the Company had 123,686,273 shares of common stock outstanding.

Stock Options

In June 2005, the stockholders of the Company approved the 2005 Stock and Incentive Plan (the 2005 Stock Plan). Upon adoption of the 2005 Stock Plan, issuance of options under the Company s existing 2000 Stock Plan ceased. Additionally, in connection with the acquisition of Solexa, the Company assumed stock options granted under the 2005 Solexa Equity Incentive Plan (the 2005 Solexa Equity Plan). The 2005 Stock Plan and the 2005 Solexa Equity Plan initially provided that an aggregate of up to 24,571,238 shares of the Company s common stock be reserved and available to be issued. The 2005 Stock Plan provides for an automatic annual increase in the shares reserved for issuance by the lesser of 5% of the outstanding shares of the Company s common stock on the last day of the immediately preceding fiscal year, 2,400,000 shares or such lesser amount as determined by the Company s board of directors. Additionally, during the Company s Annual Meeting of Stockholders held on May 16, 2008, the stockholders ratified an amendment to increase the maximum number of shares of common stock authorized for issuance under the 2005 Stock Plan by 2,400,000 shares. As of September 28, 2008, options to purchase 7,354,951 shares remained available for future grant under the 2005 Stock Plan and 2005 Solexa Equity Plan.

On January 29, 2008, the Company s board of directors approved the New Hire Stock and Incentive Plan, which provides for the issuance of options and shares of restricted stock to newly hired employees. There is no set number of shares reserved for issuance under this Plan.

The Company s stock option activity under all stock option plans during the nine months ended September 28, 2008 is as follows:

	Options	Weighted-Average Exercise Price
Outstanding at December 30, 2007	20,847,868	$ 12.13
Granted	2,891,100	$ 35.14

Exercised	(4,198,514)	$	8.66
Cancelled	(1,198,002)	$	20.14
Outstanding at September 28, 2008	18,342,452	$	16.01

The following is a further breakdown of the options outstanding as of September 28, 2008:

Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Life in Years	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price of Options Exercisable
$0.05-3.59	1,835,126	4.12	$ 2.63	1,196,336	$ 2.43
$3.71-4.30	1,882,382	5.52	$ 4.16	1,055,597	$ 4.11
$4.35-8.68	2,134,796	6.19	$ 6.20	1,208,687	$ 6.06
$8.87-13.17	1,990,508	6.65	$ 11.00	793,852	$10.94
$13.30-17.00	1,864,597	8.12	$ 15.16	554,006	$14.75
$17.04-19.61	2,103,877	7.91	$ 18.65	660,973	$18.47
$19.71-20.04	2,247,680	7.48	$ 20.03	597,805	$20.04
$20.12-32.49	2,501,686	9.04	$ 27.45	278,538	$26.64
$32.58-42.02	1,551,800	9.49	$ 35.08	34,062	$34.10
$44.38-44.38	230,000	9.85	$ 44.38		$
$0.05-44.38	18,342,452	7.23	$ 16.01	6,379,856	$10.06

The weighted average remaining life in years of options exercisable is 6.44 years as of September 28, 2008.

The aggregate intrinsic value of options outstanding and options exercisable as of September 28, 2008 was $484.5 million and $206.3 million, respectively. Aggregate intrinsic value represents the product of the number of options outstanding and the difference between the Company s closing stock price per share on the last trading day of the fiscal period, which was $42.40 on September 26, 2008, and the exercise price. Total intrinsic value of options exercised was $39.8 million and $42.2 million for the nine months ended September 28, 2008 and September 30, 2007, respectively.

Employee Stock Purchase Plan

In February 2000, the board of directors and stockholders adopted the 2000 ESPP. A total of 15,467,426 shares of the Company s common stock have been reserved for issuance under the ESPP. The ESPP permits eligible employees to purchase common stock at a discount, but only through payroll deductions, during defined offering periods.

The price at which stock is purchased under the ESPP is equal to 85% of the fair market value of the common stock on the first or last day of the offering period, whichever is lower. The initial offering period commenced in July 2000. In addition, beginning with fiscal 2001, the ESPP provides for annual increases of shares available for issuance by the lesser of 3% of the number of outstanding shares of the Company s common stock on the last day of the immediately preceding fiscal year, 3,000,000 shares or such lesser amount as determined by the Company s board of directors. Shares totaling 276,198 were issued under the ESPP during the nine months ended September 28, 2008. As of September 28, 2008, there were 10,794,162 shares available for issuance under the ESPP.

Restricted Stock Units

In 2007 the Company began granting restricted stock units pursuant to its 2005 Stock Plan as part of its regular annual employee equity compensation review program. Restricted stock units are share awards that, upon vesting, will deliver to the holder shares of the Company s common stock. Restricted stock units granted during 2007 vest over four years as follows: 15% vest on the first and second anniversaries of the grant date, 30% vest on the third anniversary of the grant date and 40% vest on the fourth anniversary of the grant date. Effective January 2008, the Company changed the vesting schedule for grants of new restricted stock units. Currently, restricted stock units vest 15% on the first anniversary of the grant date, 20% on the second anniversary of the grant date, 30% on the third anniversary of the grant date and 35% on the fourth anniversary of the grant date.

A summary of the Company s restricted stock unit activity and related information for the nine months ended September 28, 2008 is as follows:

	Restricted Stock Units (1)
Outstanding at December 30, 2007	394,500
Awarded	655,480
Vested	
Cancelled	(29,740)
Outstanding at September 28, 2008	1,020,240

(1) Each stock unit represents the fair market value of one share of common stock.

The weighted average grant-date fair value per share for the restricted stock units was $39.27 for the nine months ended September 28, 2008.

Based on the closing price of the Company s common stock of $42.40 on September 26, 2008, the total pretax intrinsic value of all outstanding restricted stock units on that date was $43.3 million.

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No restricted stock units were outstanding as of September 30, 2007.

Warrants

In conjunction with its acquisition of Solexa, the Company assumed 4,489,686 warrants issued by Solexa prior to the acquisition. During the nine months ended September 28, 2008, there were 337,384 warrants exercised, resulting in cash proceeds to the Company of approximately $3.0 million.

A summary of all warrants outstanding as of September 28, 2008 is as follows:

Number of Shares	Exercise Price	Expiration Date
238,510	$ 7.27	4/25/2010
864,040	$ 7.27	7/12/2010
809,246	$ 10.91	11/23/2010
1,125,734	$ 10.91	1/19/2011
18,322,320 (1)	$ 31.44	2/15/2014
21,359,850		

(1) Represents warrants sold in connection with the offering of the Company s Convertible Senior Notes (See Note 11).

Treasury Stock

In connection with its issuance of $400.0 million principal amount of 0.625% Convertible Senior Notes due 2014 on February 16, 2007, the Company repurchased 11.6 million shares of its outstanding common stock for approximately $201.6 million in privately negotiated transactions concurrently with the offering. Additionally, during 2007, the Company repurchased approximately 3.2 million shares of its common stock under a Rule 10b5-1 trading plan for approximately $50.0 million. This plan expired during 2007.

11. Convertible Senior Notes

On February 16, 2007, the Company issued $400.0 million principal amount of 0.625% Convertible Senior Notes due 2014 (the Notes), which included the exercise of the initial purchasers option to purchase up to an additional $50.0 million aggregate principal amount of Notes. The net proceeds from the offering, after deducting the initial purchasers discount and offering expenses, were approximately $390.3 million. The Company will pay 0.625% interest per annum on the principal amount of the Notes, payable semi-annually in arrears in cash on February 15 and August 15 of each year. The Company made an interest payment of approximately $1.2 million on August 15, 2008. The Notes mature on February 15, 2014.

The Notes will be convertible into cash and, if applicable, shares of the Company s common stock, $0.01 par value per share, based on a conversion rate, subject to adjustment, of 45.8058 shares per $1,000 principal amount of Notes (which represents a conversion price of approximately $21.83 per share), only in the following circumstances and to the following extent: (1) during the five business-day period after any five consecutive trading period (the measurement period) in which the trading price per Note for each day of such measurement period was less than 97% of the product of the last reported sale price of the Company s common stock and the conversion rate on each such day; (2) during any calendar quarter after the calendar quarter ending April 1, 2007, if the last reported sale price of the Company s common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the applicable conversion price in effect on the last trading day of the immediately preceding calendar quarter; (3) upon the occurrence of specified events; and (4) the Notes will be convertible at any time on or after November 15, 2013 through the third scheduled trading day immediately preceding the maturity date. The requirements of the second condition were satisfied during the first quarter of 2008. Accordingly, the Company s outstanding convertible notes became convertible into cash and, if applicable, shares of common stock, during the period from, and including April 1, 2008 through, and including, June 30, 2008. The Company has determined that the requirements of this same condition have again been satisfied in each of the second and third quarters of 2008. Accordingly, the Notes will continue to be convertible through, and including, December 31, 2008. Generally upon conversion of a Note, the Company will pay the conversion value of the Note in cash, up to the principal amount of the Note. Any excess of the conversion value over the principal amount is payable in shares of the Company s common stock. As of September 28, 2008, the principal amount of these Notes was classified as current liabilities. If, during the fourth quarter, none of the conditions to convertibility are satisfied, then the Company will reclassify the principal amount of these Notes to long-term debt.

In connection with the offering of the Notes in February 2007, the Company entered into convertible note hedge transactions (the hedge) with the initial purchasers and/or their affiliates (the counterparties) entitling the Company to purchase up to 18,322,320 shares of the Company s common stock at a strike price of approximately $21.83 per share, subject to adjustment. In addition, the Company sold to these counterparties warrants (the warrants) exercisable, on a cashless basis, for up to 18,322,320 shares of the Company s common stock at a strike price of $31.435 per share, subject to adjustment. The cost of the hedge that was not covered by the proceeds from the sale of the warrants was approximately $46.6 million and was reflected as a reduction of additional paid-in capital. The hedge is expected to reduce the potential equity dilution upon conversion of the Notes to the extent the Company exercises the note hedges to purchase shares from the counterparties to deliver to converting noteholders. However, the warrants could have a dilutive effect on the Company s earnings per share to the extent that the price of the Company s common stock exceeds the strike price of the warrants on the exercise dates of the warrants, which occur during 2014, and the warrants are exercised.

12. Legal Proceedings

In the recent past, the Company incurred substantial costs in defending against patent infringement claims and expects, going forward, to devote substantial financial and managerial resources to protect the Company s intellectual property and to defend against any future claims asserted against the Company.

Applied Biosystems Litigation

On December 26, 2006, Applied Biosystems Inc. (Applied Biosystems), formerly known as Applera Corporation, filed suit in California Superior Court, Santa Clara County against Solexa (which was acquired by the Company on January 26, 2007). This State Court action was related to the ownership of several patents assigned in 1995 to Solexa s predecessor company (Lynx Therapeutics) by a former employee (Dr. Stephen Macevicz), who is the inventor of these patents and is named as a co-defendant in the suit. Lynx was originally a unit of Applied Biosystems but was spun out in 1992. On May 31, 2007, Applied Biosystems filed a second suit, this time against the Company, in the U.S. District Court for the Northern District of California. This second suit sought a declaratory judgment of non-infringement of the Macevicz patents that are the subject of the State Court action mentioned above. Both suits were later consolidated in the U.S. District Court for the Northern District of California, San Francisco Division. By these consolidated actions, Applied Biosystems is seeking ownership of the Macevicz patents, unspecified costs and damages, and a declaration of non-infringement and invalidity of these patents. Applied Biosystems is not asserting any claim for patent infringement against the Company. The case is currently scheduled to go to trial on December 1, 2008.

The Macevicz patents relate to methods for sequencing DNA using successive rounds of oligonucleotide probe ligation (sequencing-by-ligation). The Company s Genome Analyzer products use a different technology called Sequencing-by-Synthesis (SBS), which the Company believes is not covered by any of these patents. In addition, the Company has no plans to use any of the Sequencing-by-Ligation technologies covered by these patents.

13. Employee Benefit Plans

Retirement Plan

The Company has a 401(k) savings plan covering substantially all of its employees. Company contributions to the plan are discretionary. During the nine months ended September 28, 2008 and September 30, 2007, the Company made matching contributions of $2.0 million and $0.9 million, respectively.

Executive Deferred Compensation Plan

For the Company s executives and members of the board of directors, the Company adopted the Illumina, Inc. Deferred Compensation Plan (the Plan) that became effective January 1, 2008. Eligible participants can contribute up to 80% of their base salary and 100% of all other forms of compensation into the Plan, including bonus, commission and director fees. The Company has agreed to credit the participants contributions with earnings that reflect the performance of certain independent investment funds. On a discretionary basis, the Company may also make employer contributions to participant accounts in any amount determined by the Company. The vesting schedules of employer contributions are at the sole discretion of the Compensation Committee. However, all employer contributions shall become 100% vested upon the occurrence of the participant s disability, death, or retirement, or a change in control of the Company. The benefits under this plan are unsecured. Participants are generally eligible to receive payment of their vested benefit at the end of their elected deferral period or after termination of their employment with the Company for any reason or at a later date to comply with the restrictions of Section 409A. As of September 28, 2008, no employer contributions were made to the Plan.

In January 2008, the Company also established a rabbi trust for the benefit of its directors and officers under the Plan. In accordance with FASB Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*, and EITF 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*, the Company has included the assets of the rabbi trust in its consolidated balance sheet since the trust s inception. As of September 28, 2008, the assets of the trust and liabilities of the Company were $1.4 million. The assets and liabilities are classified as other assets and accrued liabilities, respectively, on the Company s balance sheet as of September 28, 2008. Changes in the values of the assets held by the rabbi trust accrue to the Company.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this Quarterly Report on Form 10-Q and the financial statements, notes thereto and related Management s Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 30, 2007 included in our Annual Report on Form 10-K. Operating results are not necessarily indicative of results that may occur in future periods.

The discussion and analysis in this Quarterly Report on Form 10-Q contain forward-looking statements that involve risk and uncertainties, such as statements of our plans, objectives, expectations and intentions. Words such as anticipate, believe, continue, estimate, expect, intend, may, plan, potential, predict, project, or s phrases, or the negatives of these words, may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking. Examples of forward-looking statements include, among others, the integration of Solexa, Inc. s (Solexa) technology with our existing technology, the commercial launch of new products, including products based on our Solexa and our VeraCode technologies, and the duration which our existing cash and other resources is expected to fund our operating activities.

Forward-looking statements are subject to known and unknown risks and uncertainties and are based on potentially inaccurate assumptions that could cause actual results to differ materially from those expected or implied by the forward-looking statements. Factors that could cause or contribute to these differences include, but are not limited to, those discussed in the subsection entitled Item 1A. Risk Factors below as well as those discussed elsewhere. Accordingly, you should not unduly rely on these forward-looking statements, which speak only as of the date of this Quarterly Report. We undertake no obligation to publicly revise these forward-looking statements to reflect circumstances or events after the date of this Quarterly Report or to reflect the occurrence of unanticipated events. You should, however, review the factors and risks we describe in the reports we file from time to time with the Securities and Exchange Commission (SEC).

Overview

We are a leading developer, manufacturer and marketer of integrated systems for the large scale analysis of genetic variation and biological function. Using our proprietary technologies, we provide a comprehensive line of products and services that currently serve the sequencing, genotyping and gene expression markets. In the future, we expect to enter the market for molecular diagnostics. Our customers include leading genomic research centers, pharmaceutical companies, academic institutions, clinical research organizations and biotechnology companies. Our tools provide researchers around the world with the performance, throughput, cost effectiveness and flexibility necessary to perform the billions of genetic tests needed to extract valuable medical information from advances in genomics and proteomics. We believe this information will enable researchers to correlate genetic variation and biological function, which will enhance drug discovery and clinical research, allow diseases to be detected earlier and permit better choices of drugs for individual patients.

Our Technologies

BeadArray Technology

We have developed a proprietary array technology that enables the large-scale analysis of genetic variation and biological function. Our BeadArray technology combines microscopic beads and a substrate in a simple proprietary manufacturing process to produce arrays that can perform many assays simultaneously. Our BeadArray technology provides a unique combination of high throughput, cost effectiveness, and flexibility. We believe that these features have enabled our BeadArray technology to become a leading platform for the emerging high-growth market of single-nucleotide polymorphism (SNP) genotyping and expect they will enable us to become a key player in the gene expression market.

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Sequencing Technology

Our DNA sequencing technology, acquired as part of the Solexa merger that was completed on January 26, 2007, is based on the use of our proprietary sequencing-by-synthesis (SBS) biochemistry. Our technology is capable of generating several billion bases of DNA sequence from a single experiment with a single sample preparation, dramatically reducing the cost and improving the practicality, of human resequencing compared to conventional technologies.

VeraCode Technology

The VeraCode technology, acquired as part of the acquisition of CyVera Corporation in April 2005, enables cost-effective, high-throughput analysis of DNA, RNA and proteins at mid- to low- multiplex range. Multiplexing refers to the number of individual pieces of information that are simultaneously extracted from one sample. In addition to Life Science research applications, we believe the molecular diagnostics market will require systems that are extremely high throughput and cost effective in this mid- to low-multiplex range. We began shipping the BeadXpress System, which uses the VeraCode technology, for Life Science research applications during the first quarter of 2007, along with several assays for the system. In the research market, we expect our customers to utilize our BeadArray technology for their higher multiplex projects and then move to our BeadXpress system for their lower multiplex projects utilizing the same assays.

Product Developments

Consumables

During the nine months ended September 28, 2008, we introduced two new products for DNA analysis: the Infinium High-Density (HD) Human1M-Duo (two samples per chip) and the Human610-Quad (four samples per chip), featuring up to 2.3 million SNPs per BeadChip. The new Infinium HD product line doubles sample throughput compared to prior generations of the product and reduces DNA input requirements by as much as seventy percent. First customer shipments of the Human610-Quad occurred in the first quarter of 2008. The Human1M-Duo BeadChips began shipment in the second quarter of 2008.

Additionally, in April 2008, we introduced a new product for RNA analysis: the HumanHT 12 Gene Expression BeadChip which enables researchers to perform whole genome gene expression on twelve samples in parallel. Shipment of this product began during the second quarter of 2008.

Instruments

During the first quarter of 2008, we launched the next-generation Genome Analyzer, the Genome Analyzer II (GAII) DNA Sequencing platform. We believe the GAII significantly improves the overall robustness and throughput of the Genome Analyzer and enables researchers to achieve industry leading accuracy and daily throughput at the lowest operating cost. Shipments began during the first quarter of 2008.

In April 2008, we launched the iScan System, a next-generation BeadChip scanner that, we believe, provides researchers conducting genotyping and gene expression studies with significantly greater throughput, enhanced automation, and improved ease of use. When used with the Human1M-Duo or the Human610-Quad and our Laboratory Information Management Systems (LIMS) and automation options, the iScan System can complete genotyping studies up to six times faster than studies run on our BeadStation. Under an Early Access Program, we began shipping the iScan System in the first quarter of 2008 to customers in both the academic and industrial sectors. However, broad commercial shipment of the iScan System did not commence until the second quarter of 2008.

Critical Accounting Policies and Estimates

General

Our discussion and analysis of our financial condition and results of operations is based upon our condensed unaudited consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of financial statements requires that management make estimates, assumptions and judgments with respect to the application of accounting policies that affect the reported amounts of assets, liabilities, revenue and expenses, and the disclosures of contingent assets and liabilities. Actual results could differ from those estimates. Our significant accounting policies are described in Note 1 to our unaudited condensed consolidated financial statements. Certain accounting policies are deemed critical if 1) they require an accounting estimate to be made based on assumptions that were highly uncertain at the time the estimate was made, and 2) changes in the estimate that are reasonably likely to occur, or different estimates that we reasonably could have used would have a material effect on our unaudited condensed consolidated financial statements.

Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors, and the Audit Committee has reviewed the disclosure. In addition, there are other items within our financial statements that require estimation, but are not deemed critical as defined above. We believe the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the unaudited condensed consolidated financial statements.

Revenue Recognition

Our revenue is generated primarily from the sale of products and services. Product revenue consists of sales of arrays, reagents, flow cells, instrumentation and oligonucleotides (oligos). Service and other revenue consists of revenue received for performing genotyping and sequencing services, extended warranty sales and amounts earned under research agreements with government grants, which are recognized in the period during which the related costs are incurred.

We recognize revenue in accordance with the guidelines established by SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. Under SAB No. 104, revenue cannot be recorded until all of the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the seller s price to the buyer is fixed or determinable; and collectibility is reasonably assured. All revenue is recorded net of any applicable allowances for returns or discounts.

Revenue for product sales is recognized generally upon shipment and transfer of title to the customer, provided no significant obligations remain and collection of the receivables is reasonably assured. Revenue from the sale of instrumentation is recognized when earned, which is generally upon shipment. Revenue for genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping and sequencing analysis data is delivered to the customer.

In order to assess whether the price is fixed and determinable, we ensure there are no refund rights. If payment terms are based on future performance or a right of return exists, we defer revenue recognition until the price becomes fixed and determinable. We assess collectibility based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If we determine that collection of a payment is not reasonably assured, revenue recognition is deferred until the time collection becomes reasonably assured, which is generally upon receipt of payment. Changes in judgments and estimates regarding application of SAB No. 104 might result in a change in the timing or amount of revenue recognized.

Sales of instrumentation generally include a standard one-year warranty. We also sell separately priced maintenance (extended warranty) contracts, which are generally for one or two years, upon the expiration of the initial warranty. Revenue for extended warranty sales is recognized ratably over the term of the extended warranty period. Reserves are provided for estimated product warranty expenses at the time the associated revenue is recognized. If we were to experience an increase in warranty claims or if costs of servicing our warrantied products were greater than our estimates, gross margins could be adversely affected.

While the majority of our sales agreements contain standard terms and conditions, we do enter into agreements that contain multiple elements or non-standard terms and conditions. Emerging Issues Task Force (EITF) No. 00-21, *Revenue Arrangements with Multiple Deliverables,* provides guidance on accounting for arrangements that involve the delivery or performance of multiple products, services, or rights to use assets within contractually binding arrangements. Significant contract interpretation is sometimes required to determine the appropriate accounting, including whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes, and if so, how the price should be allocated among the deliverable elements, when to recognize revenue for each element, and the period over which revenue should be recognized. We recognize revenue for delivered elements only when we determine that the fair values of undelivered elements are known and there are no uncertainties regarding customer acceptance.

Investments

Effective January 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. SFAS 157-2, *Effective Date of FASB Statement No. 157*, which provides a one year deferral of the effective date of SFAS No. 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. In October 2008, the FASB issued FASB FSP SFAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. The FSP clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

We have adopted the provisions of SFAS No. 157 with respect to financial assets and liabilities only and will adopt the provisions for non-financial assets and non-financial liabilities effective December 29, 2008. We have assessed the fair value of our financial assets and liabilities in an inactive market in accordance with SFAS No. 157-3.

We determine fair value of our financial assets and liabilities in accordance with SFAS No. 157 and 157-3. Fair value is defined under SFAS No. 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS No. 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

In using this fair value hierarchy and the framework established by SFAS No. 157, management may be required to make assumptions of pricing by market participants and assumptions about risk, specifically when using unobservable inputs to determine fair value. These assumptions are judgmental in nature and may significantly affect our results of operations.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We evaluate the collectibility of our accounts receivable based on a combination of factors. We regularly analyze customer accounts, review the length of time receivables are outstanding and review historical loss rates. If the financial condition of our customers were to deteriorate, additional allowances could be required.

Inventory Valuation

We record adjustments to inventory for potentially excess, obsolete or impaired goods in order to state inventory at net realizable value. We must make assumptions about future demand, market conditions and the release of new products that will supersede old ones. We regularly review inventory for excess and obsolete products and components, taking into account product life cycle and development plans, product expiration and quality issues, historical experience and our current inventory levels. If actual market conditions are less favorable than anticipated, additional inventory adjustments could be required.

Contingencies

We are subject to legal proceedings primarily related to intellectual property matters. Based on the information available at the balance sheet dates and through consultation with our legal counsel, we assess the likelihood of any adverse judgments or outcomes of these matters, as well as the potential ranges of probable losses. If losses are probable and reasonably estimable, we will record a liability in accordance with SFAS No. 5, *Accounting for Contingencies*.

Goodwill and Intangible Asset Valuation

We make significant judgments in relation to the valuation of goodwill and intangible assets resulting from acquisitions and litigation settlements.

In determining the carrying amounts of our goodwill and intangible assets arising from acquisitions, we use the purchase method of accounting. The purchase method of accounting requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development (IPR&D). Goodwill and intangible assets deemed to have indefinite lives are not amortized, but are subject to at least annual impairment tests. The amounts and useful lives assigned to other acquired intangible assets impact future amortization, and the amount assigned to IPR&D is expensed immediately.

Determining the fair values and useful lives of intangible assets acquired as part of litigation settlements also requires the exercise of judgment. While there are a number of different generally accepted valuation methods to estimate the value of intangible assets, we used the discounted cash flow method in determining the value of licensed technology associated with the settlement of our Affymetrix litigation. This method required significant management judgment to forecast the future operating results used in the analysis. In addition, other significant estimates were required such as residual growth rates and discount factors. The estimates we used to value and amortize intangible assets were consistent with the plans and estimates that we use to manage our business and were based on available historical information and industry estimates and averages. These judgments can significantly affect our net operating results.

SFAS No. 142, *Goodwill and Other Intangible Assets,* requires that goodwill and certain intangible assets be assessed for impairment using fair value measurement techniques. If the carrying amount of a reporting unit exceeds its fair value, then a goodwill impairment test is performed to measure the amount of the impairment loss, if any. The goodwill impairment test compares the implied fair value of the reporting unit s goodwill with the carrying amount of that goodwill. The implied fair value of goodwill is determined in the same manner as in a business combination. Determining the fair value of the implied goodwill is judgmental in nature and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. Estimates of fair value are primarily determined using discounted cash flows and market comparisons. These approaches use significant estimates and assumptions, including projection and timing of future cash flows, discount rates reflecting the risk inherent in future cash flows, perpetual growth rates, determination of appropriate market comparables, and determination of whether a premium or discount should be applied to comparables. It is reasonably possible that the plans and estimates used to value these assets may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges. We have performed our annual test of goodwill as of May 30, 2008 noting no impairment. No indicators have arisen since management s assessment on May 30, 2008 that would require further assessment.

Impairment of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* if indicators of impairment exist, we assess the recoverability of the affected long-lived assets by determining whether the carrying value of such assets can be recovered through undiscounted future operating cash flows. If impairment is indicated, we measure the future discounted cash flows associated with the use of the asset and adjust the value of the asset accordingly. Certain estimates and assumptions are used in determining the fair value of long-lived assets. These estimates and assumptions are judgmental in nature and could have a significant impact on the determination of the recognition of an impairment charge and the magnitude of any such change. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges.

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment.* Under the provisions of SFAS No. 123(R), stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense over the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of these assumptions used in the BSM model change significantly, stock-based compensation expense resulting from new equity awards may differ materially in the future from that recorded in the current period.

Income Taxes

In accordance with SFAS No. 109, *Accounting for Income Taxes*, the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for the expected future tax benefit to be derived from tax loss and credit carryforwards. Deferred tax assets and liabilities are determined using the enacted tax rates in effect for the years in which those tax assets are expected to be realized. A valuation allowance is established when it is more likely than not the future realization of all or some of the deferred tax assets will not be achieved. The evaluation of the need for a valuation allowance is performed on a jurisdiction by jurisdiction basis, and includes a review of all available positive and negative evidence. As of September 28, 2008, we have maintained a valuation allowance only against certain U.S. and foreign deferred tax assets that we concluded have not met the more likely than not threshold required under SFAS No. 109.

Due to the adoption of SFAS No. 123(R), we recognize excess tax benefits associated with share-based compensation to stockholders equity only when realized. When assessing whether excess tax benefits relating to share-based compensation have been realized, we follow the with-and-without approach, excluding any indirect effects of the excess tax deductions. Under this approach, excess tax benefits related to share-based compensation are not deemed to be realized until after the utilization of all other tax benefits available to us.

Effective January 1, 2007, we adopted FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. FIN No. 48 requires that we recognize the impact of a tax position in our financial statements only if that position is more likely than not of being sustained upon examination by taxing authorities, based on the technical merits of the position. Any interest and penalties related to uncertain tax positions will be reflected in income tax expense.

Results of Operations

To enhance comparability, the following table sets forth our unaudited condensed consolidated statements of operations for the specified reporting periods stated as a percentage of total revenue.

	Three Months Ended		Nine months Ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
Revenue:				
Product revenue	93%	92%	92%	89%
Service and other revenue	7	8	8	11
Total revenue	100	100	100	100
Costs and expenses:				
Cost of product revenue	34	35	34	33
Cost of service and other revenue	2	3	3	4
Research and development	18	20	17	21
Selling, general and administrative	26	25	26	28
Impairment of manufacturing equipment			1	
Amortization of intangible assets	2	1	2	1
Acquired in-process research and development	17		6	119
Total costs and expenses	99	84	89	206
Income (loss) from operations	1	16	11	(106)
Interest and other income, net	2	4	1	4

Income (loss) before income taxes	3	20	12	(102)
Provision for income taxes	8	5&n		