ILLUMINA INC
Form 10-Q
October 30, 2006

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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 October 1, 2006

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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 13, 2006, there were 46,507,858 shares of the Registrant s Common Stock outstanding.

ILLUMINA, INC.
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	October 1, 2006 (unaudited)	January 1, 2006 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 44,166	$ 50,822
Short-term investments	125,776	
Accounts receivable, net	29,045	17,620
Inventory, net	19,397	10,309
Prepaid expenses and other current assets	2,519	959
Total current assets	220,903	79,710
Property and equipment, net	25,388	16,131
Goodwill	2,125	2,125
Intangible and other assets, net	8,061	2,644
Total assets	$ 256,477	$ 100,610
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 33,362	$ 21,600
Current portion of long-term debt	94	118
Total current liabilities	33,456	21,718
Long-term debt, less current portion		54
Deferred gain on sale of land and building	2,562	2,843
Other long-term liabilities	9,385	3,498
Commitments and contingencies		
Stockholders equity	211,074	72,497
Total liabilities and stockholders equity	$ 256,477	$ 100,610

(1) The Condensed Consolidated Balance Sheet at January 1, 2006

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	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Revenue:				
Product revenue	$ 46,918	$ 16,285	$ 106,582	$ 41,085
Service and other revenue	6,441	2,724	16,503	8,198
Research revenue	113	507	1,066	1,205
Total revenue	53,472	19,516	124,151	50,488
Costs and expenses:				
Cost of product revenue (including non-cash stock compensation expense of $360, $0, $858 and $0, respectively)	14,523	5,845	34,111	13,815
Cost of service and other revenue (including non-cash stock compensation expense of $57, $0, $159 and $0, respectively)	1,833	754	5,114	2,117
Research and development (including non-cash stock compensation expense of $955, $16, $2,790 and $48, respectively)	7,744	7,078	24,547	20,289
Selling, general and administrative (including non-cash stock compensation expense of $2,383, $101, $6,405 and $167, respectively)	14,118	7,377	39,143	19,930
Acquired in-process research and development				15,800
Total costs and expenses	38,218	21,054	102,915	71,951
Income (loss) from operations	15,254	(1,538)	21,236	(21,463)
Interest and other income, net	1,996	171	3,420	424
Income (loss) before income taxes	17,250	(1,367)	24,656	(21,039)
Provision for income taxes	1,088	59	1,830	161
Net income (loss)	$ 16,162	$ (1,426)	$ 22,826	$ (21,200)

Net income (loss) per basic share	$ 0.35	$ (0.03)	$ 0.52	$ (0.53)
Net income (loss) per diluted share	$ 0.32	$ (0.03)	$ 0.48	$ (0.53)
Shares used in calculating basic net income (loss) per share	46,293	40,910	43,766	39,806
Shares used in calculating diluted net income (loss) per share	50,579	40,910	48,004	39,806

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	
	October 1, 2006	October 2, 2005
Operating activities:		
Net income (loss)	$ 22,826	$ (21,200)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Acquired in-process research and development		15,800
Depreciation and amortization	4,218	2,629
Loss on disposal of property and equipment	31	74
Amortization of premium on investments		(14)
Stock-based compensation expense	10,212	215
Amortization of gain on sale of land and building	(281)	(281)
Changes in operating assets and liabilities:		
Accounts receivable	(11,049)	(6,957)
Inventory	(8,978)	(3,355)
Prepaid expenses and other current assets	(1,566)	(131)
Other assets	(2,287)	(4)
Accounts payable and accrued liabilities	11,265	5,254
Accrued litigation judgment		(5,957)
Other long-term liabilities	5,828	2,839
Net cash provided by (used in) operating activities	30,219	(11,088)
Investing activities:		
Cash paid for acquisition, net of cash acquired		(2,388)
Investment in secured convertible debentures	(3,036)	
Purchases of available-for-sale securities	(188,238)	
Sales and maturities of available-for-sale securities	62,400	12,248
Purchases of property and equipment	(13,477)	(8,866)
Cash paid for intangible assets	(15)	
Net cash provided by (used in) investing activities	(142,366)	994
Financing activities:		
Payments on long-term debt	(78)	(54)
Proceeds from issuance of common stock	105,586	5,052
Net cash provided by financing activities	105,508	4,998

Effect of foreign currency translation on cash and cash equivalents	(17)	479
Net decrease in cash and cash equivalents	(6,656)	(4,617)
Cash and cash equivalents at beginning of period	50,822	54,789
Cash and cash equivalents at end of period	$ 44,166	$ 50,172

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 2005 audited financial statements and footnotes included in the Company s Annual Report on Form 10-K for the year ended January 1, 2006, as filed with the Securities and Exchange Commission (SEC) on March 6, 2006.

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 October 1, 2006 and October 2, 2005 were both 13 and 39 weeks, respectively.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

Revenue Recognition

The Company s revenue is generated primarily from the sale of products and services. Product revenue consists of sales of arrays, reagents, instrumentation and oligos, as well as freight revenue. Service and other revenue consists of revenue received for performing genotyping services, extended warranty sales and revenue earned from milestone payments.

The Company recognizes revenue in accordance with the guidelines established by SEC Staff Accounting Bulletin (SAB) No. 104. 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. However, in the case of BeadLabs, revenue is recognized upon the completion of installation, training and customer acceptance. Revenue for genotyping services is recognized when earned, which is generally at the time the genotyping analysis data is delivered to the customer or as specific milestones are achieved.

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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 or a right of return exists, 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. 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. 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 products under warranty 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. 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. 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.

Some of the Company s agreements contain multiple elements that include milestone payments. Revenue from a milestone achievement is recognized when earned, as evidenced by acknowledgement from the Company s collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) the performance obligations for both the Company and its collaborators after the milestone achievement will continue at a level comparable to the level before the milestone achievement. If all of these criteria are not met, the milestone achievement is recognized over the remaining minimum period of the Company s performance obligations under the agreement. The Company defers non-refundable upfront fees received under its collaborations and recognizes them over the period the related services are provided or over the estimated collaboration term using various factors specific to the collaboration. Advance payments received in excess of amounts earned are classified as deferred revenue until earned.

Research revenue consists of amounts earned under research agreements with government grants, which is recognized in the period during which the related costs are incurred.

Cash and Cash Equivalents

Cash and cash equivalents are comprised of short-term, highly liquid investments primarily consisting of money market-type funds and commercial paper.

Investments

The Company applies Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to its investments. Under SFAS No. 115, the Company classifies its investments as available-for-sale and records such assets at estimated fair value in the balance sheet, with unrealized gains and losses, if any, reported in stockholders equity. The Company invests excess cash balances in marketable debt securities, including auction rate certificates, commercial paper and corporate bonds and notes, with strong credit ratings or short maturity mutual funds providing similar financial returns. The Company limits the amount of investment exposure as to institutions, maturity and investment type.

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Stock-Based Compensation

On January 2, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment*, which addresses the accounting for stock-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. In January 2005, the SEC issued SAB No. 107, which provides supplemental implementation guidance for SFAS No. 123R. SFAS No. 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and instead generally requires that such transactions be accounted for using a fair-value-based method. The Company uses the Black-Scholes-Merton option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*, in prior periods. The Company has elected to use the modified prospective transition method as permitted by SFAS No. 123R and, accordingly, prior periods have not been restated to reflect the impact of SFAS No. 123R. The modified prospective transition method requires that stock-based compensation expense be recorded for all new and unvested stock options, restricted stock and employee stock purchase plan (ESPP) shares that are ultimately expected to vest as the requisite service is rendered. Stock-based compensation expense for awards granted prior to January 2, 2006 is based on the grant date fair-value as determined under APB No. 25. For the three and nine months ended October 1, 2006, the Company has recorded an incremental $3.8 million and $10.2 million, respectively, of stock-based compensation expense as a result of the adoption of SFAS No. 123R. Net income per diluted share was reduced by $0.07 and $0.21, respectively, for the three and nine months ended October 1, 2006 as a result of the adoption of SFAS No. 123R. Stock-based compensation expense capitalized as part of inventory as of October 1, 2006 was approximately $0.1 million. As of October 1, 2006, approximately $46.7 million of total unrecognized compensation cost related to stock options, restricted stock and ESPP shares are expected to be recognized over a weighted-average period of approximately two years.

Prior to the adoption of SFAS No. 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25. The Company applied the disclosure provisions of SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, as if the fair-value-based method had been applied in measuring stock-based compensation expense. Under APB Opinion No. 25, when the exercise price of the Company s employee stock options was not less than the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table illustrates the effect on net loss and basic and diluted net loss per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the specified reporting periods (in thousands, except per share amounts):

	Three Months Ended October 2, 2005	Nine Months Ended October 2, 2005
Net loss as reported	$ (1,426)	$ (21,200)
Add: Stock-based compensation expense recorded	117	215
Less: Assumed stock-based compensation expense	(2,202)	(6,343)
Pro forma net loss	$ (3,511)	$ (27,328)
Basic and diluted net loss per share:		
As reported	$ (0.03)	$ (0.53)

Pro forma	$ (0.09)	$ (0.69)

SFAS No. 123R requires the use of a valuation model to calculate the fair-value of stock-based awards. The Company has elected to use the Black-Scholes-Merton option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The expected volatility is based on the historical volatility of the Company s common stock over the most recent period 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 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 ESPP during those periods are as follows:

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Interest rate stock options	4.83 5.05%	4.03%	4.36 5.05%	3.89%
Interest rate stock purchases	4.08 4.85%	3.25 4.08%	4.08 4.85%	3.25 4.08%
Volatility stock options	75%	88%	76%	90%
Volatility stock purchases	76 90%	90 103%	76 90%	90 103%
Expected life stock options	6 years	5 years	6 years	5 years
Expected life stock purchases	6 12 Months	6 24 months	6 12 months	6 24 months
Expected dividend yield	0%	0%	0%	0%
Weighted average fair value per share of options granted	$ 24.40	$ 8.76	$ 18.35	$ 6.80
Weighted average fair value per share of employee stock purchases	$ 5.27	$ 1.92	$ 4.76	$ 1.81

Net Income (Loss) per Share

Basic and diluted net income (loss) per share 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 typically computed using the weighted average number of common and dilutive common equivalent shares from stock options 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):

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Weighted-average shares outstanding	46,331	40,954	43,804	39,859
Less: Weighted-average shares of common stock subject to repurchase	(38)	(44)	(38)	(53)
Weighted-average shares used in calculating basic net income (loss) per share	46,293	40,910	43,766	39,806
Plus: Effect of dilutive potential common shares	4,286		4,238	
Weighted-average shares used in calculating diluted net income (loss) per share	50,579	40,910	48,004	39,806

The total number of shares excluded from the calculation of diluted net loss per share, prior to application of the treasury stock method, was 7,000,840 for the three and nine months ended October 2, 2005.

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on the Company s available-for-sale securities, changes in the fair value of derivatives designated as effective cash flow hedges, and foreign currency translation adjustments.

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

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net income (loss)	$ 16,162	$ (1,426)	$ 22,826	$ (21,200)
Foreign currency translation adjustments	30	4	190	53
Unrealized gain on forward contracts		3		62
Unrealized gain (loss) on investments	(49)		32	29
Unrealized loss on cash flow hedges			(10)	
Total other comprehensive income (loss)	$ 16,143	$ (1,419)	$ 23,038	$ (21,056)

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Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued 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 the Company recognize the impact of a tax position in its financial statements if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN No. 48 are effective as of the beginning of the Company s 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company does not expect the adoption of FIN No. 48 to have a material impact on its consolidated results of operations and financial position, and the Company is continuing to evaluate the impact, if any, the adoption of FIN No. 48 will have on its disclosure requirements.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The Company does not expect the adoption of SAB No. 108 to have a material impact on its consolidated results of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement applies only to fair value measurements that are already required or permitted by other accounting standards. Accordingly, this Statement does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on its consolidated results of operations and financial position.

2. Acquisition of CyVera Corporation

On April 8, 2005, the Company completed its acquisition of 100% of the voting equity interests of CyVera Corporation (CyVera). Pursuant to an Agreement and Plan of Merger, dated as of February 22, 2005 (the Merger Agreement), by and among Illumina, Semaphore Acquisition Sub, Inc., a Delaware corporation and wholly-owned subsidiary of Illumina (Merger Sub), and CyVera, Merger Sub merged with and into CyVera, with CyVera surviving as a wholly-owned subsidiary of Illumina. The results of CyVera s operations have been included in the Company s consolidated financial statements since the acquisition date of April 8, 2005.

CyVera was created in October 2003 to commercialize its technology and optical instrumentation/reader concepts. The Company believes that the CyVera technology, branded VeraCode , is highly complementary to the Company s own portfolio of products and services and will enhance the Company s capabilities to service its existing customers as well as accelerate the development of additional technologies, products and services. The Company believes that integrating CyVera s capabilities with the Company s technologies will better position the Company to address the emerging biomarker research and development and in-vitro and molecular diagnostic markets. The Company plans to launch its first products resulting from this acquisition over the next few quarters.

Pursuant to the Merger Agreement, the Company issued 1.6 million shares (the Shares) of common stock, paid $2.3 million in cash and assumed the net liabilities of CyVera. In addition, the Company assumed the outstanding stock options of CyVera. Approximately 250,000 of the Shares were deposited into an escrow account with a bank to satisfy any claims for indemnification made by the Company or CyVera pursuant to the Merger Agreement. No claims for indemnification were made and the escrow agent released the shares from escrow during the second quarter of 2006.

The results of CyVera s operations have been included in the accompanying unaudited condensed consolidated financial statements from the date of the acquisition. The total cost of the acquisition is as follows (in thousands):

Fair market value of securities issued, net	$ 14,433
Cash paid	2,291
Transaction costs	681

Fair market value of options assumed	394
Total purchase price	$ 17,799

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The fair value of the Shares was determined based on the average closing price of the Company s common stock for five trading days preceding, and following, February 22, 2005 (the date the transaction was announced). The Company believes that this time period gives proper consideration to matters such as price fluctuations and quantities traded and represents a reasonable period before and after the date on which the terms of the acquisition were agreed. Based on these closing prices, the Company estimated the fair value of its common stock to be $9.167 per share, which equates to a total fair value of $14.4 million.

The final purchase price allocation is shown below (in thousands):

Cash	$ 4
Prepaid expenses	12
Fixed assets	349
Deferred compensation	196
Accounts payable and accrued liabilities	(432)
Debt assumed	(255)
Net book value of net liabilities acquired	(126)
In-process research and development	15,800
Goodwill	2,125
Net assets acquired	$ 17,799

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, the goodwill is not amortized, but will be subject to a periodic assessment for impairment by applying a fair-value-based test. None of this goodwill is expected to be deductible for tax purposes. The Company performs its annual test for impairment of goodwill in May of each year. The Company is required to perform a periodic assessment between annual tests in certain circumstances. The Company has performed its annual test of goodwill and has determined there was no impairment of goodwill as of October 1, 2006.

The Company allocated $15.8 million of the purchase price to in-process research and development projects. In-process research and development (IPR&D) represents the estimated fair value of acquired, to-be-completed research projects. At the acquisition date, CyVera s ongoing research and development initiatives were primarily involved with the development of its VeraCode technology and optical instrumentation/reader concepts. These two projects were approximately 50% and 25%, respectively, complete at the date of acquisition.

The value assigned to purchased IPR&D was determined by estimating the costs to develop the acquired technology into commercially viable products, estimating the resulting net cash flows from the projects, and discounting the net cash flows to their present value. The revenue projections used to value the IPR&D were, in some cases, reduced based on the probability of developing a new technology, and considered the relevant market sizes and growth factors, expected trends in technology, and the nature and expected timing of new product introductions by the Company and its competitors. The resulting net cash flows from such projects are based on the Company s estimates of cost of sales, operating expenses, and income taxes from such projects. The rates utilized to discount the net cash flows to their present value were based on estimated cost of capital calculations. Due to the nature of the forecast and the risks associated with the projected growth and profitability of the developmental projects, discount rates of 30% were considered appropriate for the IPR&D. The Company believes that these discount rates were commensurate with the projects stage of development and the uncertainties in the economic estimates described above.

If these projects are not successfully developed, the sales and profitability of the combined company may be adversely affected in future periods. The Company believes that the foregoing assumptions used in the IPR&D analysis were reasonable at the time of the acquisition. No assurance can be given, however, that the underlying

assumptions used to estimate expected project sales, development costs or profitability are accurate or the events associated with such projects will transpire as estimated. At the date of acquisition, the development of these projects had not yet reached technological feasibility, and the research and development in progress had no alternative future uses. Accordingly, the $15.8 million initially allocated to IPR&D was charged to expense in the second quarter of 2005.

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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 those periods (in thousands, except per share data):

	Three Months Ended October 2, 2005	Nine Months Ended October 2, 2005
Revenue	$ 19,516	$ 50,488
Net loss	$ (1,538)	$ (6,762)
Basic and diluted net loss per share	$ (0.03)	$ (0.16)

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 $15.8 million non-cash acquired IPR&D charge recorded upon the closing of the acquisition during the second quarter of 2005.

3. Segment Information

The Company has determined that, in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, it operates in one segment as it only reports operating results on an aggregate basis to chief operating decision makers of the Company.

4. 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. 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):

	October 1, 2006	January 1, 2006
Raw materials	$ 7,379	$ 4,575
Work in process	9,012	4,546
Finished goods	3,006	1,188
	$ 19,397	$ 10,309

5. Intangible Assets

Intangible assets consist of license agreements and acquired technology. The cost of the Company s license agreements was $859,450 and the Company has amortized $805,617 through October 1, 2006.

6. Warranties

The Company generally provides a one-year warranty on instrument 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 component of cost of service and other revenue and are recognized ratably over the term of the maintenance contract.

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

Balance at January 1, 2006	$ 751
Additions charged to cost of revenue	925
Repairs and replacements	(759)
Balance at October 1, 2006	$ 917

7. Accounts Payable and Accrued Liabilities

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

	October 1, 2006	January 1, 2006
Accounts payable	$ 10,614	$ 7,390
Compensation	5,789	4,922
Legal and other professional fees	2,610	2,311
Short-term deferred revenue	5,878	1,937
Customer deposits	4,091	1,361
Reserve for product warranties	917	751
Other	3,463	2,928
	$ 33,362	$ 21,600

8. Stockholders Equity

On May 24, 2006, the Company completed a public offering of 4,025,000 shares of its common stock at a public offering price of $25.50 per share. This transaction generated net proceeds of $96.5 million for the Company and was completed pursuant to a shelf registration statement initially filed with the SEC in May 2006.

As of October 1, 2006, the Company had 46,506,258 shares of common stock outstanding, of which 4,814,243 shares were sold to employees and consultants subject to restricted stock agreements. The restricted common shares vest in accordance with the provisions of the agreements, generally over five years. All unvested shares are subject to repurchase by the Company at the original purchase price. As of October 1, 2006, 37,500 shares of common stock were subject to repurchase. In addition, the Company also issued 12,000 shares for a restricted stock award to an employee under the Company s 2005 Stock and Incentive Plan based on service performance. These shares vest monthly over a three-year period.

2005 Stock and Incentive Plan

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. The 2005 Stock Plan provides that an aggregate of up to 11,542,358 shares of the Company s common stock be reserved and available to be issued. In addition, the 2005 Stock Plan provides for an automatic annual increase in the shares reserved for issuance by the lesser of 5% of the number of outstanding shares of the Company s common stock on the last day of the immediately preceding fiscal year, 1,200,000 shares or such lesser amount as determined by the Company s board of directors. As of October 1, 2006, options to purchase 2,846,050 shares remained available for future grant under the 2005 Stock Plan.

The Company s stock option activity under all stock option plans during the specified reporting period is as follows:

	Options	Weighted-Average Exercise Price

Outstanding at January 1, 2006	7,325,431	$ 7.96
Granted	2,455,100	$ 26.43
Exercised	(922,864)	$ 7.06
Cancelled	(229,776)	$ 10.85
Outstanding at October 1, 2006	8,627,891	$ 13.23

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Following is a further breakdown of the options outstanding as of October 1, 2006:

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
$0.03 5.75	1,603,501	6.46	$ 3.87	987,657	$ 3.67
$5.99 8.30	1,518,262	6.28	$ 7.03	695,971	$ 7.33
$8.35 9.08	1,486,201	7.96	$ 8.65	414,728	$ 8.72
$9.09 16.03	1,510,090	7.73	$ 12.04	619,210	$ 11.22
$16.25 26.13	1,438,987	9.08	$ 21.74	181,382	$ 20.88
$26.16 45.00	1,070,850	9.77	$ 32.64	12,000	$ 34.22
$0.03 45.00	8,627,891	7.76	$ 13.23	2,910,948	$ 8.07

The aggregate intrinsic value of options outstanding and options exercisable as of October 1, 2006 was $172.5 million and $72.7 million, respectively. Aggregate intrinsic value represents the difference between the Company s closing stock price on the last trading day of the fiscal period, which was $33.04 as of September 29, 2006, and the exercise price multiplied by the number of options outstanding. Total intrinsic value of options exercised was $21.6 million for the nine months ended October 1, 2006.

2000 Employee Stock Purchase Plan

In February 2000, the board of directors and stockholders adopted the 2000 Employee Stock Purchase Plan (the Purchase Plan). A total of 4,827,988 shares of the Company s common stock have been reserved for issuance under the Purchase Plan. The Purchase Plan 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 Purchase Plan 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 Purchase Plan 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, 1,500,000 shares or such lesser amount as determined by the Company s board of directors. 147,654 and 266,394 shares were issued under the Purchase Plan during the three and nine months ended October 1, 2006, respectively. As of October 1, 2006, there were 2,762,936 shares available for issuance under the Purchase Plan.

9. Commitments and Long-Term Debt

Deferred Gain / Building Loan

In July 2000, the Company entered into a ten-year lease to rent space in two newly constructed buildings in San Diego that are now occupied by the Company. That lease contained an option to purchase the buildings together with certain adjacent land that has been approved for construction of an additional building. The Company exercised that option and purchased the properties in January 2002 and assumed a $26.0 million, ten-year mortgage on the property at a fixed interest rate of 8.36%. The Company made monthly payments of $208,974, representing interest and principal, through August 2004.

In June 2004, the Company entered into a conditional agreement to sell its land and buildings for $42.0 million and to lease back such property for an initial term of ten years. The sale was completed in August 2004 at which time the lease was signed. After the repayment of the remaining $25.2 million debt and other related transaction expenses, the

Company received $15.5 million in net cash proceeds. The Company removed the land and net book value of the buildings of $36.9 million from its balance sheet, deferred the resulting $3.7 million gain on the sale of the property, and is amortizing the deferred gain over the ten-year lease term in accordance with SFAS No. 13, *Accounting for Leases*.

Operating Leases

In August 2004, the Company entered into a ten-year lease for its corporate headquarters in San Diego, California after the land and building were sold (as discussed above). Under the terms of the lease, the Company paid a $1.9 million security deposit and is

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currently paying monthly rent of $338,048 with an annual increase of 3% in each subsequent year through August 2014. The lease contains an option to renew for three additional periods of five years each. In accordance with SFAS No. 13, the Company records rent expense on a straight-line basis and the resulting deferred rent is included in other long-term liabilities in the accompanying unaudited condensed consolidated balance sheets. The Company also leases an office and laboratory facility in Connecticut, additional office, distribution and storage facilities in San Diego, and four foreign facilities located in Japan, Singapore, China and the Netherlands under non-cancelable operating leases that expire at various times through June 2011. These leases contain renewal options ranging from one to five years.

10. Legal Proceedings

The Company has incurred substantial costs in defending itself against patent infringement claims, and expects to devote substantial financial and managerial resources to protect its intellectual property and to defend against the claims described below as well as any future claims asserted against it.

Affymetrix Litigation

On July 26, 2004, Affymetrix, Inc. (Affymetrix) filed a complaint in the U.S. District Court for the District of Delaware alleging that the use, manufacture and sale of the Company s BeadArray products and services, including the Company s Array Matrix and BeadChip products, infringe six Affymetrix patents. Affymetrix seeks an injunction against the sale of products, if any, that are determined to be infringing these patents, unspecified monetary damages, interest and attorneys fees. On September 15, 2004, the Company filed its answer to Affymetrix complaint, seeking declaratory judgments from the court that it does not infringe the Affymetrix patents and that such patents are invalid, and the Company filed counterclaims against Affymetrix for unfair competition and interference with actual and prospective economic advantage.

On February 15, 2006, the court allowed the Company to file its first amended answer and counterclaims, adding allegations of inequitable conduct with respect to all six asserted Affymetrix patents, violation of Section 2 of the Sherman Act, and unclean hands. In March 2006, Affymetrix notified the Company of its decision to drop one of the six patents from the suit, and of its intention to assert infringement of certain additional claims of the remaining five patents. The Company has filed a motion to preclude Affymetrix from asserting infringement of those additional claims. That motion is still pending at this time. On June 30, 2006, the court dismissed the patent Affymetrix had sought to withdraw from the suit. Affymetrix and the Company filed summary judgment motions by the July 14, 2006 court-established deadline. On August 16, 2006, the court issued a ruling on the Markman (claim construction) hearing it had held on April 20, 2006. The Company believes the court s Markman opinion construed several key claim terms in favor of the Company and did not adversely affect the Company s defenses and pending counterclaims in any material respect. At the request of the parties, trial has been rescheduled to March 5, 2007 from October 16, 2006. The Company believes it has meritorious defenses against each of the infringement claims alleged by Affymetrix and intends to defend vigorously against this suit. However, the Company cannot be sure that it will prevail in this matter. Any unfavorable determination, and in particular, any significant cash amounts required to be paid by the Company or prohibition of the sale of its products and services, could result in a material adverse effect on its business, financial condition and results of operations.

Dr. Anthony W. Czarnik v. Illumina, Inc.

On June 15, 2005, Dr. Anthony Czarnik, a former employee, filed suit against the Company in the U.S. District Court for the District of Delaware seeking correction of inventorship of certain of the Company s patents and patent applications, and alleging that the Company committed inequitable conduct and fraud in not naming him as an inventor. Dr. Czarnik seeks an order requiring the Company and the U.S. Patent and Trademark Office to correct the inventorship of certain of the Company s patents and patent applications by adding Dr. Czarnik as an inventor, a judgment declaring certain of the Company s patents and patent applications unenforceable, unspecified monetary damages and attorney s fees. On August 4, 2005, the Company filed a motion to dismiss the complaint for lack of standing and failure to state a claim. While this motion was pending, Dr. Czarnik filed an amended complaint on September 23, 2005. On October 7, 2005, the Company filed a motion to dismiss the amended complaint for lack of standing and failure to state a claim. On July 13, 2006, the court granted the Company s motion to dismiss the counts of Dr. Czarnik s complaint dealing with correction of inventorship in pending applications and inequitable conduct. On

July 27, 2006, the Company filed its answer to the two remaining counts of the amended complaint (correction of inventorship in issued patents, and fraud). There has been no trial date set for this case. The Company believes it has meritorious defenses against these claims.

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11. Collaboration Agreements

Invitrogen Corporation

In December 2004, the Company entered into a strategic collaboration with Invitrogen Corporation (Invitrogen). The goal of the collaboration is to combine the Company s expertise in oligonucleotide manufacturing with the sales, marketing and distribution capabilities of Invitrogen. In connection with the collaboration, the Company has developed the next generation Oligator® DNA synthesis technology. This technology includes both plate- and tube-based capabilities. Under the terms of the agreement, Invitrogen paid the Company an upfront non-refundable collaboration payment of $2.3 million during the first quarter of 2005. Additionally, Invitrogen made a milestone payment of $1.1 million to the Company in November 2005 upon achievement of a milestone event under the terms of the collaboration.

The Company began manufacturing and shipping the plate-based and certain tube-based oligo products under the collaboration in the third quarter of 2005 and, therefore, has begun to amortize the upfront collaboration payment of $2.3 million as product revenue over the life of the agreement on a straight-line basis. The unamortized portion of the collaboration payment has been recorded as short- and long-term deferred revenue. The Company recorded the $1.1 million milestone payment in service and other revenue upon achievement of the milestone during the fourth quarter of 2005. The Company recorded revenue related to this milestone payment upon its achievement, as evidenced by acknowledgment from Invitrogen and due to the fact that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) the performance obligations for both the Company and Invitrogen after the milestone achievement will continue at a level comparable to the level before the milestone achievement. In addition, the agreement provides for the transfer of the Company s Oligator technology into two Invitrogen facilities outside North America. The Company recognizes product revenue upon shipment of collaboration products based on the Company s actual manufacturing cost. Collaboration profit, as defined in the collaboration agreement, from the sale of collaboration products is divided equally between the two companies and is recorded as product revenue.

deCODE genetics

In May 2006, the Company and deCODE genetics, ehf. (deCODE) executed a Joint Development and Licensing Agreement (the Development Agreement). Pursuant to the Development Agreement, the parties agreed to collaborate exclusively to develop, validate and commercialize specific diagnostic tests for variants in genes involved in three disease-related pathways: the gene-encoding leukotriene A4 hydrolase, linked to heart attack; the gene-encoding transcription factor 7-like 2 (TCF7L2), linked to type 2 diabetes; and the gene-encoding BARD1, linked to breast cancer. The Company and deCODE intend to develop these diagnostic tests for use on the Company s BeadXpress system.

Under the agreement, the Company will be responsible for the manufacturing, marketing and selling of the diagnostic products. The companies will share the development costs of these products and split the profits from sales of the diagnostics tests. The Development Agreement may be terminated as to a particular product under development if one party decides to discontinue funding the development of that product, and may be terminated in whole by either party if the other party commits an uncured material breach, files for bankruptcy or becomes insolvent. Under a separate supply agreement, the Company installed instrumentation at deCODE that will enable deCODE to perform whole genome association studies on up to 100,000 samples using the Company s Sentrix® HumanHap300 BeadChips and associated reagents. The Company has deferred approximately $2.0 million of revenue for instruments installed during the third quarter of 2006 under guidance provided by SFAS No. 48, *Revenue Recognition When Right of Return Exists.* This amount is classified as a long-term liability as of October 1, 2006. The Company has also deferred approximately $1.3 million of costs related to product shipments to deCODE, which are classified as a long-term asset as of October 1, 2006.

12. Investment in Genizon BioSciences Inc.

In January 2006, Genizon BioSciences Inc. (Genizon), a Canadian company focused on gene discovery, purchased from the Company approximately $1.9 million in equipment and committed to purchase an additional $4.3 million in consumables. Genizon is using Illumina s HumanHap300 BeadChip along with the Infinium® assay to perform

whole-genome association studies involving thousands of members of the Quebec Founder Population. The goal of the studies is to provide understanding of the genetic origins and mechanisms of common diseases which may then lead to possible drug targets.

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In March 2006, the Company entered into a Subscription Agreement for Secured Convertible Debentures with Genizon. Pursuant to the agreement, the Company purchased a secured convertible debenture (the debenture) of Genizon and certain warrants for CDN$3.5 million (approximately U.S. $3.0 million).

The debenture is convertible, automatically upon the occurrence of a liquidity event, as defined in the debenture, into Class H Preferred Shares of Genizon. Upon the occurrence of certain events, Illumina may be entitled to receive additional shares of Genizon s Class H Preferred Shares. The debenture matures two years from issuance and bears interest, payable semiannually, at a rate of 5% per annum for the first year and 12.5% per annum for the second year. Unless the debenture is converted before maturity, 112.5% of the principal amount of the debenture is due upon maturity. Illumina also received warrants to purchase 226,721 shares of Genizon Class H Preferred Shares at an exercise price of $1.5437 per share.

As of October 1, 2006, the debenture was recorded at face value, which is the fair value, and is classified in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as an available-for-sale security.

The Company has concluded that the purchase of the debenture and the concurrent purchase by Genizon of Illumina s products are linked transactions under guidance contained in EITF No. 00-21. Since the transactions are considered linked, the Company has deferred approximately $3.0 million of revenue (the face value of the Debentures) as of October 1, 2006, related to the Genizon product shipments. The deferred revenue is classified as a long-term liability as of October 1, 2006. This amount is expected to remain in deferred revenue until Genizon settles the Debenture in cash or when a liquidity event occurs that generates cash or a security that is readily convertible into cash. The Company has also deferred approximately $1.1 million of costs related to product shipments to Genizon as a long-term asset as of October 1, 2006. All Genizon shipments that generate revenue over the face value of the debenture will be evaluated under the Company s revenue recognition policy, which is outlined in Note 1.

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 and notes thereto for the year ended January 1, 2006 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 si 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, statements regarding the integration of CyVera s technology with our existing technology, the commercial launch of new products, including products based on CyVera s technology, 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 develop, manufacture and market next-generation tools for the large-scale analysis of genetic variation and biological function. Understanding genetic variation and biological function is critical to the development of personalized medicine, a key goal of genomics. Using our technologies, we have developed a comprehensive line of products that are designed to provide the performance, throughput, cost effectiveness and flexibility necessary to

enable researchers in the life sciences and pharmaceutical industries to perform the billions of tests necessary to extract medically valuable information from advances in genomics and proteomics. This information is expected to correlate genetic variation and biological function with particular disease states, enhancing drug discovery and clinical research, allowing diseases to be detected earlier and permitting better choices of drugs for individual patients.

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In 2001, we began commercial sale of short pieces of DNA called oligonucleotides, which we refer to as oligos, manufactured using our proprietary Oligator technology. We believe our Oligator technology is more cost effective than competing technologies, and this advantage enabled us to market our oligos under a price leadership strategy while still achieving attractive gross margins. In 2001, we also commercialized the first implementation of our BeadArray technology, the Sentrix Array Matrix. This is a disposable matrix of 96 fiber optic bundles arranged in a pattern that matches the standard 96-well microtiter plate. Each fiber optic bundle may perform more than 1,500 unique assays, which enables researchers to perform focused genotyping experiments in a high-throughput format. This format was also used to initiate our single nucleotide polymorphism (SNP) genotyping services product line. As a result of the increasing market acceptance of our high throughput, low cost BeadArray technology, we have entered into genotyping service contracts with many leading genotyping centers.

In 2002, we announced the launch of a production-scale, turn-key platform, the BeadLab, which includes all hardware and software necessary to enable researchers to perform genetic analysis research. This system is being marketed to a small number of high throughput genotyping users.

In 2003, we announced the launch of several new products, including:

a new array format, the Sentrix BeadChip, which significantly expanded market opportunities for our BeadArray technology and provides increased experimental flexibility for life science researchers;

a gene expression product line on both the Sentrix Array Matrix and the Sentrix BeadChip that allows researchers to analyze a focused set of genes across eight to 96 samples on a single array; and

a benchtop SNP genotyping and gene expression system, the BeadStation, for performing moderate-scale genotyping and gene expression using our technology. The BeadStation includes our BeadArray Reader and analysis software and is designed to match the throughput requirements and variable automation needs of individual research groups and core labs.

Sales of these products began in the first quarter of 2004 and, as of October 1, 2006, we have shipped 211 BeadArray Readers, including those shipped with all BeadLabs and BeadStations.

In late 2004, we announced a strategic collaboration with Invitrogen Corporation (Invitrogen) to synthesize and distribute oligos. In the third quarter of 2005, we began shipping oligo products in connection with this agreement. As part of the agreement, we have developed the next generation of our Oligator DNA synthesis technology, which we have designed to support both plate- and the larger tube-based oligo markets. Invitrogen is responsible for sales, marketing and technical support and we are responsible for manufacturing. Profits from sales of collaboration products are divided equally between the two companies.

In 2005, we began shipments of Sentrix BeadChips for whole-genome gene expression and whole-genome genotyping. The whole-genome gene expression BeadChips are designed to enable high-performance, cost-effective, whole-genome expression profiling of multiple samples on a single chip, resulting in a dramatic reduction in cost of whole-genome expression analysis. Our whole-genome expression product line now includes multi-sample products for the Human, Mouse and Rat Genomes. The whole-genome genotyping BeadChip is designed to scale up to high levels of multiplexing without compromising data quality and to provide scientists the ability to query hundreds of thousands of SNPs in parallel. In the second quarter of 2005, we commenced shipment of our first whole-genome genotyping BeadChip, the HumanHap-1, which interrogates more than 100,000 SNPs in parallel. In the fourth quarter of 2005, we began shipping the new Sentrix HumanHap300 Genotyping BeadChip to customers around the world. Using the Infinium assay, which enables us to select virtually any SNP in the genome, the HumanHap300 BeadChip allows analysis of more than 317,000 SNPs. We selected the SNPs for inclusion on the chip in collaboration with a consortium of scientists that are leaders in the genotyping field.

In the second quarter of 2005, we completed the acquisition of CyVera Corporation, a privately-held Connecticut-based company, pursuant to which CyVera became a wholly-owned subsidiary of Illumina. We believe that CyVera s digital-microbead technology, renamed the VeraCode technology, is highly complementary to our portfolio of products and services. The acquisition is expected to provide us with a comprehensive approach to bead-based assays for biomarker research and development and in-vitro and molecular diagnostic opportunities,

including those that require low-complexity as well as high-complexity testing. We plan to launch our first products based on the VeraCode technology over the next few quarters. The purchase price associated with this transaction was approximately $17.8 million. We allocated $15.8 million of this purchase price to acquired in-process research and development and charged such amount against earnings in the second quarter of 2005.

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In 2006, we announced the launch of several new products, including:

Sentrix HumanHap240S BeadChip. The HumanHap240S BeadChip is a companion to our Sentrix HumanHap300 BeadChip for genome-wide disease association studies that enables researchers to interrogate an additional 240,000 SNPs utilizing our Infinium assay. We began shipment of this product in the first quarter of 2006.

Sentrix HumanHap550 BeadChip. The HumanHap550 BeadChip contains over 550,000 SNPs on a single microarray. We began shipment of this product in the second quarter of 2006.

Illumina AutoLoader. The AutoLoader automates BeadChip loading and scanning and increases lab throughput. The AutoLoader is designed to support up to two BeadArray Readers simultaneously for unattended operation. We began shipment of AutoLoaders in the second quarter of 2006.

Sentrix HumanHap650Y BeadChip. The HumanHap650Y BeadChip contains over 650,000 SNP markers on a single microarray, which we believe provides the most comprehensive genomic coverage and highest data quality of any whole-genome genotyping product currently available. We began shipment of this product in the third quarter of 2006.

Sentrix HumanHap550+ BeadChip. The HumanHap550+ BeadChip allows customers to add up to 120,000 custom SNP markers to supplement the standard content provided on the existing Sentrix HumanHap550 BeadChip, yielding up to 670,000 markers for association studies.

iSelect Infinium genotyping products. The iSelect Infinium genotyping product line is used for focused content applications. Customers can create a custom array of up to 60,000 SNP markers per sample with 12 samples per chip. We began shipment of these products in the third quarter of 2006.

HumanHap300-Duo and the Human Hap300-Duo+ Genotyping BeadChips. The HumanHap300-Duo allows researchers to analyze two samples simultaneously, with over 634,000 total tag SNPs on a single BeadChip. The HumanHap300-Duo+ allows for the addition of 60,000 custom SNP loci to the base product, enabling researchers to enrich that product with SNPs of interest in any genomic region.

RatRef-12 Expression BeadChip. The RatRef-12 Expression BeadChip enables analysis of 12 samples in parallel on a single BeadChip. Content for this BeadChip is derived from the NCBI RefSeq database (Release 16), with over 22,000 rat transcripts represented.

Our revenue is subject to fluctuations due to the timing of sales of high-value products and service projects, the impact of seasonal spending patterns, the timing and size of research projects our customers perform, changes in overall spending levels in the life science industry and other unpredictable factors that may affect our customer ordering patterns. Any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in our existing product lines, or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue. Due to the possibility of fluctuations in our revenue and net income or loss, we believe quarterly comparisons of our operating results are not a good indication of our future performance.

Prior to 2006, we incurred substantial operating losses. As of October 1, 2006, our accumulated deficit was $121.8 million and total stockholders equity was $211.1 million. Losses prior to 2006 have principally occurred as a result of the substantial resources required for the research, development and manufacturing scale-up effort required to commercialize our products and services, an acquired in-process research and development charge of $15.8 million related to our acquisition of CyVera and a charge of $5.9 million related to a termination-of-employment lawsuit. We expect to continue to incur substantial costs for research, development and manufacturing scale-up activities over the next several years. We will also need to increase our selling, general and administrative costs as we build up our sales

and marketing infrastructure to expand and support the sale of systems, other products and services.

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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, instrumentation and oligos, as well as freight revenue. Service and other revenue consists of revenue received for performing genotyping services, extended warranty sales and revenue earned from milestone payments.

We recognize revenue in accordance with the guidelines established by SEC Staff Accounting Bulletin (SAB) No. 104. 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. However, in the case of BeadLabs, revenue is recognized upon the completion of installation, training and customer acceptance. Revenue for genotyping services is recognized when earned, which is generally at the time the genotyping analysis data is delivered to the customer or as specific milestones are achieved.

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.

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Some of our agreements contain multiple elements that include milestone payments. Revenue from a milestone achievement is recognized when earned, as evidenced by acknowledgement from our collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) the performance obligations for both us and our collaborators after the milestone achievement will continue at a level comparable to the level before the milestone achievement. If all of these criteria are not met, the milestone achievement is recognized over the remaining minimum period of our performance obligations under the agreement. We defer non-refundable upfront fees received under our collaborations and recognize them over the period the related services are provided or over the estimated collaboration term using various factors specific to the collaboration. Advance payments received in excess of amounts earned are classified as deferred revenue until earned.

Research revenue consists of amounts earned under research agreements with government grants, which is recognized in the period during which the related costs are incurred.

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 supercede 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 Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*. Currently, we have no such liabilities recorded. This may change in the future depending upon new developments in each matter.

Goodwill and Intangible Asset Valuation

The purchase method of accounting for acquisitions 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 especially requires the exercise of judgment. While there are a number of different acceptable generally accepted valuation methods to estimate the value of intangible assets acquired, we primarily use the discounted cash flow method. This method requires significant management judgment to forecast the future operating results used in the analysis. In addition, other significant estimates are required such as residual growth rates and discount factors. The estimates we use to value and amortize intangible assets are consistent with the plans and estimates that we use to manage our business and are based on available historical information and industry estimates and averages. These judgments can significantly affect our net operating results.

During fiscal 2001, we adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 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

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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. As of October 1, 2006, we had $2.1 million of goodwill. This goodwill is reported as a separate line item in the balance sheet. We have performed our annual test of goodwill and have determined there has been no impairment of goodwill as of October 1, 2006.

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123R, *Share-Based Payment*. Under the provisions of SFAS No. 123R, 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 may differ materially in the future from that recorded in the current period.

Income Taxes

We record a tax provision for the anticipated tax consequences of the reported results of operations. 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 operating losses and tax credit carryforwards. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those tax assets are expected to be realized or settled. A valuation allowance for the full amount of the resulting net deferred tax asset has been recorded, as the future realization of the tax benefit is uncertain. As of October 1, 2006, we have maintained the full valuation allowance against our deferred tax assets as we have not met the more likely than not threshold required under SFAS No. 109.

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	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Revenue:				
Product revenue	88%	83%	86	81%
Service and other revenue	12	14	13	16
Research revenue		3	1	3
Total revenue	100	100	100	100
Costs and expenses:				
Cost of product revenue	27	30	27	28
Cost of service and other revenue	3	4	4	4
Research and development	14	36	20	41
Selling, general and administrative	27	38	32	39

Acquired in-process research and development				31
Total costs and expenses	71	108	83	143
Income (loss) from operations	29	(8)	17	(43)
Interest and other income, net	3	1	3	1
Income (loss) before income taxes	32	(7)	20	(42)
Provision for income taxes	2		1	
Net income (loss)	30%	(7)%	19%	(42)%

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Three and Nine Months Ended October 1, 2006 and October 2, 2005

Our 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 October 1, 2006 and October 2, 2005 were both 13 and 39 weeks, respectively.

Revenue

	Three Months Ended			Nine Months Ended		
	October 1, 2006	October 2, 2005	Percentage Change	October 1, 2006	October 2, 2005	Percentage Change
	(in thousands)			(in thousands)		
Product revenue	$ 46,918	$ 16,285	188%	$ 106,582	$ 41,085	159%
Service and other revenue	6,441	2,724	136%	16,503	8,198	101%
Research revenue	113	507	(78)%	1,066	1,205	(12)%
Total revenue	$ 53,472	$ 19,516	174%	$ 124,151	$ 50,488	146%

Total revenue for the three and nine months ended October 1, 2006 and October 2, 2005 was $53.5 million and $124.2 million, and $19.5 million and $50.5 million, respectively. This represents an increase of $34.0 million, or 174%, and $73.7 million, or 146%, compared to the three and nine months ended October 2, 2005.

Product revenue increased to $46.9 million and $106.6 million, respectively, for the three and nine months ended October 1, 2006, from $16.3 million and $41.1 million, respectively, for the three and nine months ended October 2, 2005. The increase in both the three and nine months ended October 1, 2006 resulted primarily from higher consumable and BeadStation sales. Growth in consumable revenue was primarily attributable to the launch and shipment of our whole genome genotyping products, the HumanHap300 and HumanHap550 BeadChips. In addition, growth in consumable revenue can be attributed to the growth in our installed base of BeadArray Readers, which has doubled since October 2, 2005. Consumable products constituted 71% and 65% of product revenue in the three and nine months ended October 1, 2006, compared to 42% and 45% in the three and nine months ended October 2, 2005. We expect to see continued growth in product revenue, which can be partially attributed to the launch of several new products, as well as the growth of our installed base of BeadArray Readers.

Service and other revenue increased to $6.4 million and $16.5 million, respectively, for the three and nine months ended October 1, 2006, from $2.7 million and $8.2 million for the three and nine months ended October 2, 2005, due primarily to the delivery of several significant Infinium and GoldenGate® SNP genotyping service contracts. We introduced our Infinium services in early 2006. We expect sales from SNP genotyping services contracts to fluctuate on a quarterly basis, depending on the mix and number of contracts that are completed. The timing of completion of a SNP genotyping services contract is highly dependent on the customer s schedule for selecting the SNPs and delivering their samples to us.

Government grants and other research funding decreased to $0.1 million and $1.1 million in the three and nine months ended October 1, 2006, from $0.5 million and $1.2 million for the three and nine months ended October 2, 2005, due primarily to the completion of several projects funded by grants from the National Institutes of Health. We do not expect research revenue to be a material component of our revenue going forward.

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Cost of Product and Service and Other Revenue

	Three Months Ended			Nine Months Ended		
	October 1, 2006	October 2, 2005	Percentage Change	October 1, 2006	October 2, 2005	Percentage Change
	(in thousands)			(in thousands)		
Cost of product revenue	$ 14,523	$ 5,845	148%	$ 34,111	$ 13,815	147%
Cost of service and other revenue	1,833	754	143%	5,114	2,117	142%