UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 8-K/A

(Amendment No. 1)

CURRENT REPORT

Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): December 3, 2020

Luna Innovations Incorporated

(Exact name of registrant as specified in its charter)

301 1st Street SW, Suite 200
Roanoke, VA 24011
(Address of principal executive offices, including zip code)

540-769-8400

(Registrant's telephone number, including area code)

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

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

☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

☐ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

☐ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

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

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	Trading Symbol	Name of each exchange on which registered
Common Stock, $0.001 par value per share	LUNA	The Nasdaq Stock Market LLC

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company ☐

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

Item 8.01 Other Events

As previously reported, on December 3, 2020, Luna Innovations Incorporated (the "Company") entered into and closed a Share Purchase Agreement (the “Share Purchase Agreement”) with QinetiQ Holdings Limited (“QinetiQ”) for the purchase of all of the shares of OptaSense Holdings Limited (“OptaSense Holdings”). This Form 8-K/A is filed as an amendment to the Form 8-K filed by the Company on December 3, 2020. The information previously reported in Form 8-K is hereby incorporated by reference into this Form 8-K/A. The purpose of this Form 8-K/A is to file the audited financial statements and pro forma information required by Item 9.01.

Item 9.01 Financial Statements and Exhibits

(a) Financial statements of businesses acquired.

The audited consolidated financial statements of OptaSense Holdings and it’s wholly owned subsidiaries as of and for the years ended March 31, 2020 and March 31, 2019 and the report of Grant Thornton LLP, independent certified public accountants, thereon, are filed herewith as Exhibit 99.1.

(b) Pro forma financial information.

The unaudited pro forma condensed consolidated balance sheet as of September 30, 2020 and the unaudited pro forma condensed consolidated income statements for the nine months ended September 30, 2020 and the year ended December 31, 2019 of the Company, giving effect to its acquisition of OptaSense Holdings, are filed herewith as Exhibit 99.2. Such unaudited pro forma condensed consolidated financial statements are not necessarily indicative of the operating results or financial position that actually would have been achieved if the acquisition had been in effect on the dates indicated or that may be achieved in future periods, and should be read in conjunction with the financial statements of the Company and OptaSense Holdings.

Item 9.01. Financial Statements and Exhibits

(d) Exhibits.

Exhibit	Description
23.1	Consent of Independent Certified Public Accountants
99.1	Audited Financial Statements of Business Acquired
99.2	Pro Forma Financial Information

SIGNATURES

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

Luna Innovations Incorporated

By: /s/ Scott A. Graeff

Scott A. Graeff
President and Chief Executive Officer

Date: June 29, 2021

Exhibit 23.1

CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

We have issued our report dated June 29, 2021, with respect to the consolidated financial statements of OptaSense Holdings Limited and its subsidiaries for the years ended March 31, 2020 and 2019 included in the Current Report on Form 8-K/A of Luna Innovations Incorporated dated June 29, 2021.

We consent to the incorporation by reference of said report in the Registration Statements of Luna Innovations Incorporated on Form S-3 (File No. 333-191809), on Form S-4 (File No. 333-201956) and on Forms S-8 (File No. 333-211802, File No. 333-204435, File No. 333-138745 and File No 333-239362).

/s/ GRANT THORNTON LLP

Arlington, Virginia
June 29, 2021

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
OptaSense Holdings Limited

We have audited the accompanying consolidated financial statements of OptaSense Holdings Limited (a United Kingdom limited company) and subsidiaries, which comprise the consolidated balance sheets as of March 31, 2020 and 2019, and the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity (deficit), and cash flows for the years then ended, and the related notes to the financial statements.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.
An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of OptaSense Holdings Limited and subsidiaries as of March 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of matter

As described in Note 1 to the consolidated financial statements, the Company adopted new accounting guidance as of April 1, 2019 related to the accounting for leases. Our opinion is not modified with respect to this matter.

/s/ GRANT THORNTON LLP

Arlington, Virginia
June 29, 2021

OptaSense Holdings Limited and Subsidiaries
Consolidated Balance Sheets
(in thousands, except share data)

	March 31, 2020		March 31, 2019	
Assets				
Current assets:				
Cash and cash equivalents	£	2,595	£	2,528
Accounts receivable, net		6,668		5,752
Contract assets		1,707		5,974
Inventory		8,140		2,933
Other current assets		1,322		209
Total current assets		20,432		17,396
Property and equipment, net		761		904
Intangible assets, net		1,741		1,920
Other assets		1,896		949
Deferred tax asset, net		19		19
Right of use asset		1,067		—
Total Assets	**£**	**25,916**	**£**	**21,188**
Liabilities and stockholders' equity (deficit)				
Current liabilities:				
Accounts payable	£	215	£	1,049
Accrued liabilities		2,117		2,382
Contract liabilities		2,450		1,002
Current portion of lease obligations		435		—
Other current liabilities		1,337		1,260
Loan from Parent		3,275		37,503
Total current liabilities		9,829		43,196
Lease liabilities, long-term		652		—
Total Liabilities		10,481		43,196
Stockholders' equity (deficit):				
Common stock (par value £0.01, 100 shares authorized, issued and outstanding)		—		—
Additional paid in capital		43,148		235
Accumulated deficit		(28,402)		(23,001)
Accumulated other comprehensive income		689		758
Total stockholders' equity (deficit)		15,435		(22,008)
Total liabilities and stockholders' equity (deficit)	**£**	**25,916**	**£**	**21,188**

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

OptaSense Holdings Limited and Subsidiaries
Consolidated Statements of Operations
(in thousands)

	Years ended March 31,	
	2020	**2019**
Revenues	£ 24,252	£ 26,108
Cost of revenues	11,206	10,141
Gross profit	13,046	15,967
Operating expense:		
Selling, general and administrative	11,899	12,850
Research and development	4,962	2,978
Total operating expense	16,861	15,828
Operating (loss) income	(3,815)	139
Other expense:		
Interest expense, net	(2,319)	(1,769)
Total other expense	(2,319)	(1,769)
Loss before income taxes	(6,134)	(1,630)
Income tax benefit (expense)	733	(339)
Net loss	**£ (5,401)**	**£ (1,969)**

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

OptaSense Holdings Limited and Subsidiaries
Consolidated Statements of Comprehensive Loss
(in thousands)

	Years ended March 31,	
	2020	**2019**
Net loss	£ (5,401)	£ (1,969)
Other comprehensive income:		
Foreign currency translation adjustment	(69)	1,771
Other comprehensive (loss) income	(69)	1,771
Total other comprehensive loss	**£ (5,470)**	**£ (198)**

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

OptaSense Holdings Limited and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity (Deficit)
(in thousands, except share data)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (loss)	Accumulated Deficit	Total Stockholders' Equity (Deficit)
Balance—April 1, 2018	100	£ —	£ 22	£ (1,013)	£ (21,032)	£ (22,023)
Unrealized gain on translation of foreign operations	—	—	—	1,771	—	1,771
Stock-based compensation	—	—	213	—	—	213
Net loss	—	—	—	—	(1,969)	(1,969)
Balance—March 31, 2019	100	—	235	758	(23,001)	(22,008)
Unrealized loss on translation of foreign operations	—	—	—	(69)	—	(69)
Contribution from Parent loan waiver	—	—	42,650	—		42,650
Stock-based compensation	—	—	263	—	—	263
Net loss	—	—	—	—	(5,401)	(5,401)
Balance—March 31, 2020	100	£ —	£ 43,148	£ 689	£ (28,402)	£ 15,435

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

OptaSense Holdings Limited and Subsidiaries
Consolidated Statements of Cash Flows
(in thousands)

	Years ended March 31,	
	2020	**2019**
Cash flows used in operating activities:		
Net loss	£ (5,401)	£ (1,969)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,023	930
Bad debt expense	201	69
Stock-based compensation	263	213
Interest forgiven on loan from Parent	2,282	—
Benefit from provision for deferred income taxes	—	(95)
Changes in operating assets and liabilities:		
Accounts receivable	(1,118)	250
Contract assets	4,267	(4,902)
Inventory	(5,206)	(54)
Prepaid expenses and other current assets	(1,113)	(154)
Other current liabilities	(62)	611
Accounts payable and accrued expenses	(1,079)	897
Contract liabilities	1,448	(1,102)
Other assets	(947)	486
Net cash used in operating activities	(5,442)	(4,820)
Cash flows used in investing activities:		
Purchases of property and equipment	(444)	(565)
Purchases of intangible property	(121)	—
Net cash used in investing activities	(565)	(565)
Cash flows provided by financing activities:		
Borrowings on Parent loan	13,447	13,055
Repayments on Parent loan	(7,304)	(7,421)
Net cash provided by financing activities	6,143	5,634
Effect of exchange rate changes on cash and cash equivalents	(69)	918
Net change in cash and cash equivalents	67	1,167
Cash and cash equivalents—beginning of period	2,528	1,361
Cash and cash equivalents—end of period	£ 2,595	£ 2,528
Supplemental disclosure of cash flow information		
Cash paid for interest	£ 55	£ —
Cash paid for income taxes	£ —	£ 409
Noncash financing activities		
Contribution from Parent loan waiver	£ 42,650	£ —

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

OptaSense Holdings Limited and subsidiaries (“we", "us" or the “Company”), formerly a wholly owned subsidiary of QinetiQ Holdings Limited (hereafter “QinetiQ”or “the Parent”) was acquired by Luna Innovations Incorporated (“Luna”) in December 2020. The Company is headquartered in Farnborough, United Kingdom, and was incorporated in 2010. The Company has operations in Canada, India, and the United States.

The Company is the market leader in providing through-life fiber-optic sensing solutions, products and services. The Company is a platform technology, providing reliable, real-time and actionable information, to protect and monitor its customers’ critical infrastructure for the Oil & Gas, Security and Transport industries.

Basis of Presentation

The consolidated financial statements include the accounts of OptaSense Holdings Limited and all of its wholly-owned subsidiaries. The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”).

All revenues and costs as well as assets and liabilities directly associated with the business activity of the Company are included in the consolidated financial statements.

All intercompany transactions between the Company and subsidiaries have been eliminated.

The tax amounts in the consolidated financial statements have been calculated based on a separate return methodology and presented as if the Company’s operations were separate taxpayers in the respective jurisdictions.

Use of Estimates

The preparation of our consolidated financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes.

Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may differ from such estimates and assumptions.

Foreign Currency

The Company’s reporting currency is the pound sterling (“£”). Monetary assets and liabilities in foreign currencies are translated at period-end rates. Items included in the financial statements of the Company are measured using the currency of the primary economic environment in which the Company operates ("the functional currency"). Transactions in foreign currencies are recorded using the date of exchange ruling at the date of the transaction. Any resulting exchange differences are recognized in the consolidated statements of operations. The exchange differences recorded in March 31, 2020 and 2019 were £0.4 million loss and £0.1 million loss, respectively.

Cash and Cash Equivalents

We consider all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents. The cash and cash equivalents balance held outside of the United Kingdom at March 31, 2020 and 2019 was £2.1 million and £2.1 million, respectively.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are amounts due from customers for goods or services sold in the ordinary course of business. Accounts receivable are recorded at their face amount, less an allowance for doubtful accounts. We review the status of our uncollected receivables on a regular basis. In determining the need for an allowance for uncollectible receivables, we consider our customers' financial stability, past payment history and other factors that bare on the ultimate collection of such amounts.

Inventory

Inventory consists of finished goods, work in process and raw materials valued at the lower of cost (determined on the weighted average basis) or net realizable value.

Property and Equipment, Net

Property and equipment are stated at cost less accumulated depreciation. We record depreciation using the straight-line method over the following estimated useful lives:

Vehicles	3 - 5 years
Equipment	3 - 10 years
Furniture and fixtures	5 - 10 years
Computer equipment	3 - 5 years
Leasehold improvements	Lesser of lease term or life of improvements

The useful lives, depreciation methods, and residual values applied to property and equipment are reviewed annually and, if appropriate, adjusted accordingly. When assets are sold or otherwise disposed, the asset and related accumulated depreciation or amortization are removed, with any gain or loss reflected in earnings. Repairs and maintenance are expensed as incurred.

Intangible Assets, Net

Purchased intangible assets are recognized at cost. Intangible assets are amortized on a straight-line basis over their respective useful lives which is ten years for intellectual property and three years for purchased software. We analyze the reasonableness of the remaining useful lives whenever events or circumstances indicate that the carrying amount may not be recoverable to determine whether the carrying value has been impaired. There were no impairment losses for the years ended March 31, 2020 and 2019.

Impairment of Long-Lived Assets

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by comparing the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of by sale are reflected at the lower of their carrying amount or fair value less cost to sell. There were no impairment losses for the years ended March 31, 2020 and 2019.

Fair Value Measurements

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

- Level 1—Quoted prices for identical instruments in active markets.
- Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant value drivers are observable.

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

The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximates fair value because of the short-term nature of these instruments. The carrying amount of lease liabilities approximates fair value because these financial instruments bear interest at rates that approximate current market rates for similar agreements with similar maturities and credit.

Revenue Recognition

Revenue from Contracts with Customers

Revenue is measured based on the consideration specified in a contract with a customer and excludes amounts collected on behalf of third parties. The Company recognizes revenue when it transfers control of a product or service to a customer. The Company assesses contracts for the existence of multiple performance obligations and accounts for these separately. Revenues from product sales are generated by the sale of commercial products and services under various sales programs to the end user and through distribution channels. We sell fiber optic test and distributed acoustic sensing systems to end users for use in numerous fiber optic-based measurement applications. Revenues are recorded net of applicable sales taxes collected from customers and payable to state or local governmental entities. The Company's methodology applies the revenue requirements on a contract-by-contract basis which includes considerations for contract modifications, variable consideration and the determination of distinct performance obligations. Shipping and handling activities primarily occur after a customer obtains control and are considered fulfillment costs rather than a separate performance obligation.

For standard products, we recognize revenue at a point in time when control passes to the customer. Absent substantial product acceptance clauses, this is based on the shipping terms. For custom products that require engineering and development based on customer requirements, we will recognize revenue over time using the output method for any items shipped. For extended warranties and product rentals, revenue is recognized over time using the output method based on the time elapsed for the warranty or service period. In the case of warranties, we record a contract liability for amounts billed but that are not recognized until subsequent periods. A separate contract liability is recorded for the cost associated with warranty repairs based on our estimate of future expense.

Service Contracts

Service contracts are transferred to the customer over a period of time as the Company fulfills its performance obligation. At contract inception the Company undertakes an assessment to determine how many distinct performance obligations exists within a contract. As part of the assessment the Company obtains an understanding of the overall deliverable to the customer through discussions with business units and project leads. Each individual deliverable in the contract is then assessed to determine if it is an input into the overall deliverable, and therefore part of a single performance obligation, or if it is a stand-alone separable deliverable with its own transaction price and therefore a distinct performance obligation in its own right. Each distinct performance obligation identified within a contract is accounted for separately. The transaction price is allocated between each distinct performance obligation identified in a contract based on the stand-alone selling price of each performance obligation. Each performance obligation will be costed, and the transaction price will be cost plus margin. This amount would be the stand-alone selling price of each performance obligation if contracted with a customer separately.

The Company's obligation to repair or replace faulty products under standard warranty terms is recognized in a provision and is not considered a performance obligation under the contract. Additional warranty can be purchased, and revenue is recognized over the period of the warranty.

Contract Assets

Contract assets is recognized if the Company's right to consideration is conditioned on something other than the passage of time.

Contract Liabilities

Contract liabilities represents deferred income. The Company, on occasion, bills customers in advance of performing certain types of work which results in the Company recognizing contract liabilities. Once the work has been performed these amounts will be reduced and recognized as revenue. For sale of goods, revenue is recognized in the consolidated statements of operations when control of the goods has been transferred to the customer; being at the point when the goods are delivered. Any transaction price received by the Company prior to that point is recognized as a contract liability.

Research and Development Expenditures

Research and development ("R&D"') costs incurred in respect of specific contracts placed by customers are recognized within costs of revenue in respect of the R&D services performed. All other R&D costs are expensed to the research and development line-item within the consolidated statements of operations in the period in which they are incurred.

Advertising

We expense the cost of advertising as incurred. Advertising expenses were £0.4 million for each of the years ended March 31, 2020 and 2019.

Income Taxes

We account for income taxes using the liability method. Deferred tax assets or liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities as measured by the enacted tax rates by jurisdiction, which will be in effect when the differences reverse. A valuation allowance against net deferred tax assets is provided unless we conclude it is more likely than not that the deferred tax assets will be realized.

We recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. We evaluate our ability to benefit from all deferred tax assets and establish valuation allowances for amounts we believe are not more-likely-than-not to be realizable. For uncertain tax positions, we use a more-likely-than-not threshold, 51% or greater, based on the technical merits of the income tax position taken. Income tax positions that meet the more-likely-than-not recognition threshold are measured in order to determine the tax benefit recognized in the financial statements. Penalties, if probable and reasonably estimable, and interest expense related to uncertain tax positions are recognized as a component of the tax provision.

The tax provision charge is based on the taxable profit for the year and takes into account taxation deferred because of temporary differences between the treatment of certain items for taxation and accounting purposes. Current tax and deferred tax are charged or credited to the profit and loss account, except where they relate to items charged or credited to equity, in which case the relevant tax is charged or credited to equity. Any changes in the tax rates are recognized in the profit and loss account unless related to items directly recognized in equity.

The Company has tax losses which are available indefinitely for offset against future taxable profits of the Company. Deferred tax assets are recognized to the extent that there is certainty over the timing of their recovery.

Recently Adopted Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, *Leases (Topic 842)* (the "New Leases Standard”). The New Leases Standard was issued to increase transparency and comparability among entities by recognizing right-of-use (“ROU”) assets and lease liabilities on the consolidated balance sheets and disclosing key information about lease arrangements. The Company adopted the New Leases Standard as of April 1, 2019 using the transition option established by ASU 2018-11, *Leases (Topic 842)*, *Targeted Improvements* (ASU 2018-11), which permits companies to adopt the New Leases Standard as of the beginning of the period of adoption without recasting financial information for prior periods presented.

The applied practical expedients at the adoption of the standard are as follows:

1. The package of transition practical expedients under Accounting Standards Codification ("ASC") 842-10-65-1 (f) (elected as a package and applied consistently to all leases) not to reassess leases that commenced before the effective date consisting in:

a) No need to reassess whether any expired or existing contracts are or contain leases.

b) No need to reassess the lease classification for any expired or existing leases.

c) No need to reassess initial direct costs for any existing leases.

2. Practical expedient to not separate lease and non-lease components.

3. Practical expedient under ASC 842-10-65-1 (g) to use hindsight to determine the likelihood of whether a lease will be extended, terminated or whether a purchase option will be exercised.

The impact upon adoption on April 1, 2019 was the recognition of £0.8 million of ROU assets and lease obligations in the consolidated balance sheets. There was no cumulative effect adjustment as a result of the adoption of the new leases standard and the impact is non-cash in nature and did not materially affect the Company's cash flows. Prior to the adoption of Topic 842, our lease accounting policy was in accordance with ASC Topic 840, *Leases*, which was superseded by Topic 842.

In December 2016, the FASB issued ASU No. 2016-20, *Technical corrections and improvements to Topic 606, Revenue from Contracts with Customers*. This update provides additional clarification and implementation guidance on the previously issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU No. 2014-09 supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing GAAP. The standard, as subsequently updated in July 2015, is effective for annual periods beginning after December 15, 2021, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). Early adoption is permitted. We adopted Topic 606 using the modified retrospective transition method, for the period beginning April 1, 2018, which applied to new contracts and those that were not completed as of April 1, 2018. The impact of adopting the new standard was not material.

In January 2017, the FASB issued ASU 2017-04 *Simplifying the Test for Goodwill Impairment*, which simplifies the test for goodwill impairment by eliminating Step 2 from the goodwill impairment test which previously measured a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount. We adopted ASU 2017-04, effective April 1, 2020. As a result of adopting the new rules, we compare the estimated fair value of our reporting segments to their respective carrying values when evaluating the recoverability of goodwill. If the carrying value of a reporting unit exceeds its fair value, an impairment charge will be recognized for the amount by which its carrying value exceeds the reporting unit's fair value; however, the loss recognized will not exceed the goodwill allocated to the reporting unit. The adoption of ASU 2017-04 did not have a significant impact on our consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13 *Fair Value Measurement* (Topic 820): *Changes to the Disclosure Requirements for Fair Value Measurement*, which amends the disclosure requirements in ASC 820 by adding, changing, or removing certain disclosures. The ASU applies to all entities that are required under this guidance to provide disclosures about recurring or nonrecurring fair value measurements. The amendments in this ASU are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. We adopted ASU 2018-13, effective April 1, 2020. The adoption of ASU 2018-13 did not have a significant impact on our consolidated financial statements.

In August 2018, the FASB issued ASU 2018-15 *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract*, which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. Subsequent to March 31, 2020, we adopted ASU 2018-15 which did not have a significant impact on our consolidated financial statements.

Recently Issued Pronouncements Not Yet Adopted

In June 2016, the FASB issued ASU 2016-13: *Financial Instruments - Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments*, which requires companies to measure financial assets at an amortized cost basis to be presented at the net amount expected to be collected. The new accounting rules eliminate the probable initial recognition threshold and, instead, reflect an entity's current estimate of all expected credit losses. ASU 2016-13 is applicable to our trade receivables. This pronouncement was amended under ASU 2019-10 to allow an extension on the adoption date for entities that qualify as a small reporting company. We have elected this extension and the effective date for us to adopt this standard will be for fiscal years beginning after December 15, 2022. We are currently in the process of evaluating the impact of ASU 2016-13, but we do not expect the adoption of this new accounting standard to have a significant impact on our consolidated financial statements.

In December 2019, the FASB issued ASU 2019-12 *Simplifying the Accounting for Income Taxes*, which removes certain exceptions to the general principles of the accounting for income taxes and also improves consistent application of and simplification of other areas when accounting for income taxes. The guidance is effective for us beginning in the first quarter of fiscal year 2021, while early adoption is permitted. Subsequent to March 31, 2020, we adopted ASU 2019-12 which did not have a significant impact on our consolidated financial statements.

2. Accounts Receivable, net

Accounts receivable, net consists of the following:

	March 31,			
(in thousands)	2020		2019	
Trade receivables	£	6,812	£	5,683
Other receivables		77		89
		6,889		5,772
Less: allowance for doubtful accounts		(221)		(20)
Accounts receivable, net	£	6,668	£	5,752

3. Inventory

Inventory consists of the following:

	March 31,			
(in thousands)	2020		2019	
Finished goods	£	5,521	£	1,087
Work-in-process		329		424
Raw materials		2,290		1,422
Inventory	£	8,140	£	2,933

4. Property and Equipment, net

Property and equipment, net consists of the following:

	March 31,			
(in thousands)	2020		2019	
Vehicles	£	534	£	516
Equipment		5,253		4,277
Furniture and fixtures		744		734
Computer equipment		301		269
Leasehold improvements		181		176
		7,013		5,972
Less: accumulated depreciation		(6,252)		(5,068)
Property and equipment, net	£	761	£	904

Depreciation expense for the years ended March 31, 2020 and March 31, 2019 was £0.6 million and £0.5 million, respectively, and is included in selling, general and administrative expense in our consolidated statements of operations.

5. Intangible Assets, net

Intangible assets, net consists of the following:

		March 31,			
(in thousands)	Estimated Life	2020		2019	
Intellectual property	10 years	£	4,225	£	4,035
Purchase software	3 years		234		111
			4,459		4,146
Less: accumulated amortization			(2,718)		(2,226)
Intangible assets, net		£	1,741	£	1,920

Amortization expense for the years ended March 31, 2020 and 2019 was approximately £0.4 million and £0.4 million, respectively, and is included in selling, general and administrative expense in our consolidated statements of operations.

Estimated aggregate amortization, based on the net value of intangible assets at March 31, 2020, for each of the next five years and beyond is as follows (amounts in thousands):

Year Ending March 31,		
2021	£	417
2022		417
2023		404
2024		377
2025		126
2026 and beyond		—
	£	1,741

We did not recognize any intangible asset impairment charges during the years ended March 31, 2020 and 2019.

6. Accrued Liabilities

Accrued liabilities consists of the following:

	March 31,			
(in thousands)	2020		2019	
Accrued compensation	£	1,637	£	1,692
Accrued interest		231		245
Accrued sales taxes		16		204
Other		233		241
Total accrued liabilities	£	2,117	£	2,382

7. Leases

We have operating leases for our equipment and facilities, which have remaining terms ranging from eight months to 5 years. Our leases do not have an option to extend the lease period beyond the stated term unless the new term is agreed by both parties. They also do not have an early termination clause included. Our operating lease agreements do not contain any material restrictive covenants.

The discount rate for our operating leases was not readily determinable in the specific lease agreements. As a result, our incremental borrowing rate was used as the discount rate when establishing the ROU assets and corresponding lease liabilities. As of March 31, 2020, we had no operating leases that have not yet commenced.

Rent expense is recognized on a straight-line basis over the life of the lease. Rent expense consists of the following:

	Year ended March 31,			
(in thousands)	2020		2019	
Operating lease costs	£	493	£	550
Variable rent costs		34		—
Total rent expense	£	527	£	550

Future minimum lease payments under non-cancelable operating leases were as follows as of March 31, 2020 (amounts in thousands):

Year Ending March 31,		
2021	£	513
2022		354
2023		172
2024		62
2025		36
2026 and beyond		—
Total future minimum lease payments		1,137
Less: Interest		50
Total lease liabilities	£	1,087

Current portion of lease obligations	£	435
Lease liabilities -long-term		652
Total lease liabilities	£	1,087

Other information related to leases is as follows:

Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from leases	£	493
Right-of-use assets obtained in exchange for new lease liabilities	£	1,529
Weighted-average remaining lease term (years)		2.63
Weighted-average discount rate		3.3 %

8. Revenue Recognition

Disaggregation of Revenue

We disaggregate our revenue from contracts with customers by timing of recognition as we believe it best depicts how the nature, amount, timing and uncertainty of our revenue and cash flows are affected by economic factors.

Revenue from contracts with customers by timing of recognition is as follows:

	March 31,			
(in thousands)	**2020**		**2019**	
Total revenue by timing of recognition:				
Goods transferred at a point in time	£	14,640	£	18,261
Services transferred over time		9,612		7,847
Total	£	24,252	£	26,108

9. Income Taxes

Income tax (benefit) expense from operations consisted of the following for the year ended:

(in thousands)	March 31, 2020	March 31, 2019
Current domestic (UK)	£ (523)	£ (37)
Current foreign (US and CN)	(210)	376
Total current tax (benefit) expense	£ (733)	£ 339
Deferred domestic (UK)	—	—
Deferred foreign (US and CN)	—	—
Total deferred tax benefit	—	—
Total tax (benefit) expense	£ (733)	£ 339

The (benefit) expense from income taxes from continuing operations differs from the amount computed by applying the statutory income tax rate to our loss from continuing operations before income taxes primarily as a result of operations in various jurisdictions with varying tax rates and permanent differences, including patent box deductions, and losses for which no benefit can be provided.

Loss before income taxes within or outside the United Kingdom are shown below:

(in thousands)	Years ended March 31, 2020	Years ended March 31, 2019
Domestic (UK)	£ (5,275)	£ (910)
Foreign (US and CN)	(859)	(720)
Total	£ (6,134)	£ (1,630)

Deferred tax assets and liabilities consist of the following components:

(in thousands)	March 31, 2020	March 31, 2019
Deferred tax assets:		
Accruals and reserves	£ 9	£ 81
Inventory	56	42
Other	19	19
Operating loss carry forwards	2,510	2,300
Intangible assets	152	126
Valuation allowance	(2,655)	(2,510)
Deferred tax asset	91	58
Deferred tax liabilities:		
Fixed assets	(72)	(39)
Deferred tax liabilities	(72)	(39)
Net deferred tax asset (liability)	£ 19	£ 19

The realization of our deferred income tax asset is dependent upon sufficient taxable income in future periods. In assessing whether deferred tax assets may be realized, we considered whether it is more likely than not that some portion, or all, of the deferred tax asset will be realized. We consider scheduled reversals of deferred tax liabilities, projected future taxable income and tax planning strategies that we can implement in making our assessment. Based on all the available evidence management has concluded that a valuation allowance of £2.6 million and £2.5 million for the period ending March 31, 2020 and March 31, 2019, respectively. The valuation is associated with the deferred tax assets in the United Kingdom and the United States.

We have income tax NOL carryforwards related to our UK operations of approximately £11.3 million. We have recorded a deferred tax asset of £2.1 million associated with these losses. Such deferred tax assets carry forward indefinitely.

We have income tax NOL carryforwards related to our US Federal operations of approximately £1.7 million. We have recorded a deferred tax asset of £0.4 million associated with these losses. Such deferred tax assets carry forward indefinitely. In addition there are insignificant deferred tax assets related to various state loss carry forwards.

The total unrecognized tax benefits of £0.2 million and £0.8 million as of March 31, 2020 and 2019, respectively. If these amounts are recognized in future periods, it would affect the effective tax rate on income from continuing operations for the years in which they are recognized.

10. Related Party

The following table shows a summary of the Company's significant related party transactions with the Parent as of March 31, 2020 and 2019, respectively:

	March 31,	
(in thousands)	**2020**	**2019**
Loan from Parent	£ 3,275	£ 37,503
Related party interest expense	£ 2,282	£ 1,831
Borrowings from Parent loan	£ 13,447	£ 13,055
Repayments on Parent loan	£ 7,304	£ 7,421
Allocated support costs from Parent	£ 2,300	£ 2,803

The consolidated financial statements also include allocations of certain expenses for services from QinetiQ, including, but not limited to corporate and shared expenses related to finance and accounting, legal, information technology, human resources, facilities, communications, ethics. These expenses have been allocated to the Company on the basis of direct usage when identifiable, with the remainder allocated on the basis of headcount, square footage or other measures. Management considers the basis on which these expenses have been allocated to be a reasonable reflection of the utilization of services provided to or benefits received by the Company during the periods presented. The allocations may not, however, reflect the expense the Company would have incurred as a stand-alone business operating independently from QinetiQ. The amount of actual costs that may have been incurred if the Company was a stand-alone business would depend on a number of factors, including the Company’s chosen organizational structure, what functions were outsourced or performed by the Company’s employees, and strategic decisions made in areas such as sourcing, marketing, information technology and infrastructure.

All significant transactions between QinetiQ and the Company have been presented in the consolidated financial statements based on the nature of the transaction. QinetiQ uses a centralized approach to treasury management, including cash, foreign exchange exposure hedging and financing of its operations and QinetiQ funds the Company's operating and investing activities as needed. The Company has historically been funded through an related party loan to QinetiQ. The related party loan is presented as Loan from Parent in the consolidated balance sheet. The Loan from Parent was renewed annually and matures on March 31 of the following year. The interest rate was three month LIBOR plus 4.50%. In March 2020, the Company was granted a waiver from it's obligation to repay the Parent loan balance of £42.7 million. Additional related party transactions

related to ordinary trade activities have been netted and presented in Other Assets and Other Current Liabilities in the consolidated balance sheet where there is no right of offset. On March 31, 2020 and 2019 the balance in Other Assets was £1.9 million and £0.9 million, respectively. On March 31, 2020 and 2019 the balance in Other Current Liabilities was £1.3 million and £1.1 million, respectively. As a result of centralized foreign exchange exposure hedging where QinetiQ enters into forward foreign exchange contracts on behalf of the whole Parent Group, derivative assets and liabilities are not specifically allocated to the Company, while the foreign currency gain or loss is attributed to the Company.

The Company participates in the Parent’s share-based payment plans. The total share-based payments expense for the years ended March 31, 2020 and 2019 were £0.3 million and £0.2 million, respectively, the majority of which is related to equity-settled awards. The expense was charged to the Company by the ultimate parent company QinetiQ. In all cases, they relate to full shares of QinetiQ, the ultimate parent company. The employees participate in the Parent's Deferred Share Plan ("DSP"). The number of awards earned is dependent on the QinetiQ's performance, such as revenue growth, during the fiscal year, for which actual awards are granted in the following June for the previous fiscal year. The actual awards granted in June for the previous fiscal year might differ from the estimate made at a fiscal year end for the purposes of share-based payment expense recognition, which is recognized as a change in estimate in the year awards are granted. Awards are then subject to a three year vesting period and a further two-year holding period, with vesting contingent upon Parent's operating profit for the year prior to vesting being maintained at the level reported during the year prior to award. No DSP's were awarded for the years ended March 31, 2020 and 2019, respectively. The fair value of DSPs awarded during the year for the prior year's performance is determined based on the closing share price of QinetiQ at the date of award (June 1, 2019).

The Company participates in the Parent's employee contribution plan in the United Kingdom, under which QinetiQ and the Company's employees pay fixed contributions to a third-party provider. The Company's portion of the contributions, which are recognized as an employee benefit expense when they are due, was £0.2 million for each of the years ended March 31, 2020 and 2019.

11. Employee Contribution Plan

The Company maintains a contribution benefit plan in Canada (Canadian RRSP plan). The plan is offered to all permanent employees. The contribution rate is a minimum of 5% with a match up to 10%. The Company contributed approximately £0.1 million to the plan for each of the years ended March 31, 2020 and March 31, 2019.

The Company maintains a contribution benefit plan under provisions of Section 401(k) of the Internal Revenue Code. The plan is offered to all permanent employees. The contribution rate is between 1% and 75%, auto deferral increases by 1% each January to maximum 10% and has a employer contribution of 100% of the first 2% plus 50% of the next 3%. The Company contributed approximately £0.2 million to the plan for each of the years ended March 31, 2020 and March 31, 2019.

12. Commitments and Contingencies

Obligation under Operating Leases

See Note 7 - Leases for discussion of our lease obligations.

Purchase Commitment

We executed a non-cancelable purchase order totaling £3.5 million in 2020 for multiple shipments of interrogator units to be delivered over an 18-month period. At March 31, 2020, approximately £1.5 million of these commitments remained.

Guarantees

As of March 31, 2020, we had a total of £1.4 million in performance bond guarantees outstanding in favor of certain third parties to ensure performance of its obligations under certain customer contracts and lease arrangements. These guarantees expire at various dates through December 31, 2020. To date, we have not incurred any charges associated with non-performance covered by such guarantees and have not accrued any liabilities as of March 31, 2020.

13. Subsequent Events

We evaluated subsequent events through June 29, 2021, the date on which these financial statements are being issued. There are no significant events that require disclosure in these financial statements, except for the following items.

On December 3, 2020, Luna entered into and closed a Share Purchase Agreement with QinetiQ for the purchase of all the shares of the Company for £29.0 million.

Since March 31, 2020, the COVID-19 pandemic has resulted in a global slowdown of economic activity. While the impact of the COVID-19 pandemic to our business and operating results presents additional uncertainty, we continue to use reasonably available information to assess certain accounting matters including, but not limited to, accounts receivable, inventory and the carrying value of long-lived tangible and intangible assets. While the assessments have not resulted in any material impacts to our financial statements as of March 31, 2020, we believe the full impact of the pandemic remains uncertain and ongoing developments related to the pandemic may cause material impacts to our consolidated financial statements.

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

On December 3, 2020, Luna Innovations Incorporated (the "Company") entered into and closed a Share Purchase Agreement (the "Share Purchase Agreement") with QinetiQ Holdings Limited ("QinetiQ" or the "Parent") for the purchase of all of the shares of OptaSense Holdings Limited ("OptaSense"). Pursuant to the Share Purchase Agreement, the Company acquired all outstanding shares of OptaSense for aggregate consideration of £29.0 million (approximately $38.9 million using the exchange rate on the purchase date) subject to adjustment as described in the Share Purchase Agreement (the "Acquisition"). In addition, for a period of two years after closing, QinetiQ has agreed not, directly or indirectly, alone or jointly with any other person, to compete or engage in any competing business with the Company in countries in which OptaSense operates and not to solicit customers, employees or suppliers of the Company, subject to specified exceptions. QinetiQ has also agreed to provide specified transitional services for a period of six months after closing.

OptaSense is a developer and supplier of advanced fiber-optic acoustic sensor systems and other related systems.

To finance the acquisition, the Company borrowed funds pursuant to a Loan Agreement dated December 1, 2020 with PNC Bank, National Association, as set forth below (collectively, the "Financing"):

- $12.5 million term loan under a term loan facility, and
- $7.6 million revolving loan under a $15.0 million revolving credit facility.

The remaining cash consideration was funded using cash on hand.

The unaudited pro forma condensed combined financial statements ("pro forma financial information") have been prepared based on the historical financial statements of the Company and OptaSense and are intended to provide information about how the Acquisition and Financing might have affected the Company's historical consolidated financial statements.

The accompanying unaudited pro forma condensed combined balance sheet as of September 30, 2020 combines the historical consolidated balance sheet of the Company, derived from the Company's Quarterly Report on Form 10-Q filed with the U.S. Securities and Exchange Commission ("SEC") on November 9, 2020, and the historical consolidated balance sheet of OptaSense as of September 30, 2020, as if such subsequent acquisition had occurred on September 30, 2020.

The Company reports its results on a calendar year basis. Prior to the Acquisition, OptaSense maintained its accounting on the basis of a fiscal year ending on March 31. Pursuant to regulations of the Securities and Exchange Commission, the Company is permitted, for the purpose of these pro forma financial statements, to combine statements of operations for periods which have different ending dates so long as the periods combined are of equal length and are not more than 93 days apart. The accompanying unaudited combined pro forma statement of operations for the year ended December 31, 2019 combines the historical consolidated results of operations of the Company, derived from the Company's Annual Report on Form 10-K filed with the SEC on March 13, 2020, and the historical consolidated results of operations of OptaSense for the most recently completed fiscal year ended March 31, 2020, as if such acquisition had occurred on January 1, 2019.

The accompanying unaudited pro forma condensed combined statement of operations for the nine months ended September 30, 2020 combines the historical consolidated results of operations of the Company, derived from the Company's Quarterly Report on Form 10-Q filed with the SEC on November 9, 2020 and the historical consolidated results of operations of OptaSense for the nine months ended September 30, 2020.

The use of the non-conforming historical year-end of OptaSense in the unaudited pro forma condensed combined statements of operations for the year ended December 31, 2019 and the nine months ended September 30, 2020 resulted in the three-months period ended March 31, 2020 to be included more than once in these unaudited pro forma condensed combined statements of operations. The historical sales and pretax loss for the three-month period ended March 31, 2020 included in both the unaudited pro forma condensed combined statements of

operations for the year ended December 31, 2019 and the nine months ended September 30, 2020 totaled $7.7 million and $0.5 million, respectively.

The historical consolidated financial information has been adjusted in the accompanying unaudited pro forma condensed combined financial information to give effect to pro forma events that are (i) directly attributable to the Acquisition and Financing, (ii) factually supportable, and (iii) with respect to the unaudited pro forma condensed combined statements of operations, expected to have a continuing impact on the combined results.

The unaudited pro forma condensed combined financial statements should be read in conjunction with the accompanying notes to the unaudited pro forma financial information and:

- the historical unaudited financial statements of Luna Innovations Incorporated for the quarter ended September 30, 2020, included in the Company's Quarterly Report on Form 10-Q filed with the SEC on November 9, 2020;
- the historical audited financial statements of Luna Innovations Incorporated for the year ended December 31, 2019, included in Company's Annual Report on Form 10-K filed with the SEC on March 13, 2020; and
- the historical audited financial statements of OptaSense for the year ended March 31, 2020, as filed in this Current Report on Form 8-K/A.

The unaudited pro forma condensed combined financial statements are presented using the acquisition method of accounting, with the Company as the acquirer. The unaudited pro forma condensed combined financial information will differ from the final acquisition accounting for a number of reasons, including that the estimates of fair values of assets acquired and liabilities assumed are preliminary and subject to change when the formal valuation is finalized. The Company measured OptaSense's assets acquired and OptaSense's liabilities assumed at their fair values as of the closing of the Acquisition. Any excess of the purchase price over the fair value of OptaSense's net assets has been recorded as goodwill.

The unaudited pro forma combined condensed financial information has been prepared by management in accordance with Article 11 of Regulation S-X of the SEC and it is not necessarily indicative of the combined financial position or combined results of operations that would have been realized had the Acquisition and related Financing all occurred as of the dates indicated, nor is it meant to be indicative of any anticipated combined financial position or future combined results of operations after the Acquisition. The accompanying unaudited pro forma condensed combined financial information is presented for illustrative purposes and does not include any expected integration activities, cost savings, synergies or restructuring actions which may be achievable subsequent to the Acquisition or the impact of any non-recurring activity and one-time transaction related costs to be incurred in the subsequent reporting periods.

UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEET OF
LUNA INNOVATIONS INCORPORATED AND OPTASENSE HOLDINGS LIMITED
SEPTEMBER 30, 2020
(in thousands)

	Historical		Pro Forma Adjustments		
Assets	**Luna**	**OptaSense**	**Financing**	**Purchase Accounting**	**Pro Forma Combined**
Current assets:					
Cash and cash equivalents	$ 26,422	$ 2,557	$ 19,914 A	$ (37,412) D	$ 11,481
Accounts receivable, net	18,254	5,346	—	—	23,600
Contract assets	4,219	2,496	—	—	6,715
Inventory, net	11,713	12,833	—	401 E	24,947
Prepaid expenses and other current assets	3,268	1,697	68 A	—	5,033
Total current assets	63,876	24,929	19,982	(37,011)	71,776
Property and equipment, net	2,111	1,266	—	—	3,377
Intangible assets, net	9,193	2,171	—	8,659 F	20,023
Goodwill	10,542	—	—	6,832 G	17,374
Long term contract assets	577	—	—	—	577
Other assets	7,855	3,168	—	551 H	11,574
Deferred tax asset	1,729	25	—	—	1,754
Total assets	$ 95,883	$ 31,559	$ 19,982	$ (20,969)	$ 126,455
Liabilities and stockholders' equity					
Current liabilities:					
Accounts payable	$ 3,177	$ 1,422	$ —	$ 2,150 I	$ 6,749
Accrued liabilities	7,716	5,075	—	582 J	13,373
Contract liabilities	3,721	2,567	—	—	6,288
Current portion of long-term debt	—	—	4,167 A	—	4,167
Total current liabilities	14,614	9,064	4,167	2,732	30,577
Long-term debt	—		15,815 A	—	15,815
Other long-term liabilities	7,761	585	—	359 J	8,705
Deferred tax liability	— —	—	—	— K	—
Loan from Parent	—	4,085	—	(4,085) L	—
Total non-current liabilities	7,761	4,670	15,815	(3,726)	24,520
Total liabilities	22,375	13,734	19,982	(994)	55,097
Stockholders' equity	73,508	17,825	—	(19,975) M	71,358
Total liabilities and stockholders' equity	$ 95,883	$ 31,559	$ 19,982	$ (20,969)	$ 126,455

The accompanying notes are an integral part of the unaudited pro forma condensed combined financial statements.

UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS OF LUNA INNOVATIONS INCORPORATED AND OPTASENSE HOLDINGS LIMITED FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2020

(in thousands, except share and per share data)

	Historical		Pro Forma Adjustments				
	Luna	OptaSense	Financing/Other		Purchase Accounting		Pro Forma Combined
Revenues:							
Lightwave	$ 39,837	$ 17,695	$ —		$ —		$ 57,532
Luna Labs	16,929	—	—		—		16,929
Total revenues	56,766	17,695	—		—		74,461
Cost of revenues:							
Lightwave	15,736	5,987	—		—		21,723
Luna Labs	12,200	—	—		—		12,200
Total cost of revenues	27,936	5,987	—		—		33,923
Gross profit	28,830	11,708	—		—		40,538
Operating expense:							
Selling, general and administrative	19,085	12,050	—		235	N	31,370
Research, development and engineering	4,717	3,129	—		—		7,846
Loss on sale of property and equipment	576	—	—		—		576
Total operating expense	24,378	15,179	—		235		39,792
Operating income (loss)	4,452	(3,471)	—		(235)		746
Other income (expense):							
Investment income	65	12	—		—		77
Other income	19	54,599	(54,599)	B	—		19
Interest expense	(2)	(908)	586	B	—		(324)
Total other income	82	53,703	(54,013)		—		(228)
Income (loss) from continuing operations before income taxes	4,534	50,232	(54,013)		(235)		518
Income tax benefit	(257)	(781)	147	C	(59)	O	(950)
Net income (loss) from continuing operations	$ 4,791	$ 51,013	$ 440		$ (176)		$ 1,468
Net income per share from continuing operations:							
Basic	$ 0.16						$ 0.05
Diluted	$ 0.15						$ 0.05
Weighted average shares:							
Basic	30,593,954						30,593,957
Diluted	32,478,625						32,478,625

The accompanying notes are an integral part of the unaudited pro forma condensed combined financial statements.

UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS OF LUNA INNOVATIONS INCORPORATED AND OPTASENSE HOLDINGS LIMITED FOR THE YEAR ENDED DECEMBER 31, 2019

(in thousands, except per share data)

	Historical		Pro Forma Adjustments		
	Luna	**OptaSense**	**Financing**	**Purchase Accounting**	**Pro Forma Combined**
Revenues:					
Products and licensing	$ 44,491	$ 30,926	$ —	$ —	$ 75,417
Technology development	26,025	—	—	—	26,025
Total revenues	70,516	30,926	—	—	101,442
Cost of revenues:					
Products and licensing	16,684	14,290	—	—	30,974
Technology development	18,649	—	—	—	18,649
Total cost of revenues	35,333	14,290	—	—	49,623
Gross profit	35,183	16,636	—	—	51,819
Operating expense:					
Selling, general and administrative	24,371	15,174	—	(17) **N**	39,528
Research, development and engineering	7,496	6,328	—	—	13,824
Total operating expense	31,867	21,502	—	(17)	53,352
Operating income	3,316	(4,866)	—	17	37
Other income (expense):					
Investment income	393	—	—	—	393
Other expense	(4)	—	—	—	(4)
Interest expense	(16)	(2,957)	2,454 **B**	—	(519)
Total other income	373	(2,957)	2,454	—	(130)
Income (loss) from continuing operations before income taxes	3,689	(7,823)	2,454	17	(1,663)
Income tax (benefit) expense	(1,654)	(935)	614 **C**	4 **O**	(1,971)
Net income (loss) from continuing operations	$ 5,343	$ (6,888)	$ 1,840	$ 13	$ 308
Net income per share from continuing operations:					
Basic	$ 0.19				$ 0.01
Diluted	$ 0.17				$ 0.01
Weighted average shares:					
Basic	28,688,867				28,688,867
Diluted	31,840,584				31,840,584

The accompanying notes are an integral part of the unaudited pro forma condensed combined financial statements.

Notes to Unaudited Pro Forma Condensed Combined Financial Statements

1. Basis of Pro forma Presentation

The unaudited pro forma condensed combined financial statements were prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and pursuant to the rules and regulations of SEC Regulation S-X and present the pro forma financial position and results of operations of the combined companies based upon the historical data of the Company and OptaSense, after giving effect to the Acquisition, related financings and pro forma adjustments as described in these notes.

Pro forma adjustments are included only to the extent they are (i) directly attributable to the Acquisition and related financings, (ii) factually supportable, and (iii) with respect to the statement of operations only, expected to have a continuing impact on the combined results. The pro forma financial information is presented for illustrative purposes only and does not reflect the costs of any integration activities or cost savings or synergies that may be achieved as a result of the Acquisition. The unaudited pro forma condensed combined statements of operations do not reflect non-recurring expenses directly attributable to the Acquisition, including fees to attorneys, accountants and other professional advisors, and other transaction-related costs. However, the impact of such expenses incurred subsequent to the balance sheet date are reflected in the unaudited pro forma condensed combined balance sheet as accrued liabilities. This amount does not include estimates for fees that are not readily determinable or factually supportable. The unaudited pro forma condensed combined statements of operations and the unaudited pro forma condensed combined balance sheet give effect to the Acquisition and the related financings as if both had occurred on January 1, 2019, and September 30, 2020, respectively.

The historical consolidated financial statements of the Company are prepared in accordance with U.S. GAAP and are shown in U.S. dollars. The historical consolidated financial statements of OptaSense are prepared in accordance with U.S. GAAP, and are translated into U.S. dollars, for purposes of the pro forma financial information. The revenue and expenses were translated using average exchange rates for the periods noted, and the assets and liabilities were translated using the exchange rate as of the balance sheet date.

The unaudited pro forma condensed combined financial statements are presented for illustrative purposes only and are not necessarily indicative of the financial position or operating results that would have been achieved had the Acquisition and related financings been completed as of the dates indicated above.

Certain amounts in OptaSense's historical balance sheet and statements of operations have been conformed to the Company's presentation.

2. Credit Agreement

In connection with the signing of the Share Purchase Agreement, on December 3, 2020, the Company entered into a Loan Agreement (the "Credit Agreement") with PNC Bank, National Association, as lender (the "Lender") and the Company's domestic subsidiaries as guarantors. The Loan Agreement provides a $12.5 million term loan facility (the "Term Loan") and a $15.0 million revolving credit facility (the "Revolving Line"), which include a $3.0 letter of credit sublimit. On December 1, 2020, the Company borrowed the full amount of the Term Loan from the Lender pursuant to a term note (the "Term Note") and a $7.6 million revolving loan (the "Revolving Loan") pursuant to a revolving line of credit note. The Company may repay and reborrow advances under the Revolving Line from time to time pursuant to the Revolving Line of Credit Note.

The Company used the proceeds from the Term Loan and the Revolving Loan to pay, in part, the consideration for the Acquisition described above. The Company's obligations under the Loan Agreement are secured by a first priority perfected security interest in substantially all of the Company's assets.

The Term Loan matures on December 1, 2023. The Term Loan is due and payable in 12 equal quarterly payments of principal and interest. The Term Loan bears interest at a floating per annum rate equal to the sum of (a) LIBOR plus (b) a margin ranging from 1.75% to 2.25% depending on the Net Leverage Ratio (as defined in the Loan Agreement). The Company may prepay the Term Loan without penalty or premium.

The Revolving Line expires on December 1, 2023. Borrowings under the Revolving Line will bear interest at a floating per annum rate equal to the sum of (a) LIBOR plus (b) a margin ranging from 1.75% to 2.25% depending on the Net Leverage Ratio. Accrued interest will be due and payable on the first day of each month and the outstanding principal balance and any accrued but unpaid interest will be due and payable on December 1, 2023. The unused portion of the Revolving Line will accrue a fee equal to 0.20% per annum multiplied by the quarterly average unused amount.

Provided that the Company's obligations under the Loan Agreement have been satisfied, the Company may terminate the Loan Agreement at any time upon three business days' advance written notice to the Lender.

3. Preliminary Purchase Price and Purchase Price Allocation

The Acquisition will be accounted for using the acquisition method of accounting, which requires an allocation of the purchase price to the net assets acquired, based on their fair values as of the date of the Acquisition. Pro forma purchase price allocation adjustments have been made for the purpose of providing pro forma financial information based on current estimates and currently available information. These amounts are preliminary and subject to revision based on final determination of fair value and the final allocation of the purchase price to the assets and liabilities of OptaSense, and the revisions could be material. The table below summarizes the preliminary allocation of purchase price to the tangible and intangible assets acquired and liabilities assumed based on management's preliminary estimates of their respective fair values for purposes of the pro forma financial information as if the Acquisition closed on September 30, 2020:

		(in thousands)
Consideration transferred	$	37,412
Cash	$	2,557
Accounts receivable		5,346
Inventory		13,234
Other current assets		4,193
Property and equipment		1,266
Other assets		3,719
Intangible assets		10,830
Deferred tax assets (liabilities), net		25
Accounts payable and other current liabilities		(8,984)
Operating lease liabilities		(1,606)
Fair value of identifiable net assets acquired		30,580
Goodwill	$	6,832

The application of the acquisition method of accounting is dependent upon certain valuations and other studies that have yet to be finalized. The purchase price allocation will remain preliminary until the Company's management determines the fair values of assets acquired and liabilities assumed. The final determination of the purchase price allocation is anticipated to be completed as soon as practicable after completion of the Acquisition and is based on the fair values of the assets acquired and liabilities assumed as of the Acquisition closing date. The final amounts allocated to assets acquired and liabilities assumed could differ significantly from the amounts presented in the unaudited pro forma condensed combined financial statements for the reasons described above.

For acquired working capital accounts, such as accounts receivable, contract assets and other current assets, accounts payable and accrued expenses, management determined that no preliminary fair value adjustments were required due to the short timeframe until settlement for these assets and liabilities. The estimated fair value of the acquired inventory was based upon the estimated selling price of the inventory less an estimate for the costs to sell the inventory, adjusted for the inventory items that were deemed slow moving.

Management will measure the lease liabilities at the present value of the remaining lease payments, as if the acquired leases were the new leases of the Company at the acquisition date. The right-of-use assets will be the same amount as the lease liabilities. Adjustment to reflect favorable or unfavorable terms of the leases when compared with market terms was not deemed to be necessary.

For purposes of this unaudited pro forma financial information, the Company used the assumption that the carrying values of OptaSense property and equipment approximates its fair value. As a result, no adjustment has been made to property and equipment depreciation expense. This is a preliminary assumption based on information currently available and is subject to revision based on the final determination of fair value.

Identifiable intangible assets acquired include the following:

		Fair value	Weighted average amortization period
		(in thousands)	*(in years)*
Trade names	$	2,481	15.0
Proprietary technology		7,095	10.0
Customer relationships		582	5.0
Backlog		672	3.0
Total fair value of identified intangible assets	**$**	**10,830**	**10.4**

The establishment of the fair value of consideration for acquisitions requires the extensive use of significant estimates and judgment to establish the fair value. Significant judgment is required in determining the estimated fair value of acquired intangible assets by using the following valuation methodologies:

Trade names: To estimate the preliminary fair value of the trade names, the Company applied the relief from royalty methodology of the income approach. This method is based on the supposition that in lieu of ownership, a company would be willing to pay a royalty in order to exploit the related benefits of the trade names. The value of the trade names was determined by discounting the inherent after-tax royalty savings associated with ownership or possession of the trade names over the expected useful life.

Proprietary technology: OptaSense internally developed coherent reflection technique for creating highly sensitive acoustic sensors. Such technology provides customers with the monitoring solutions for traffic flow, perimeter security, a pipeline leak detection, applications for oil field services, and other, which has a value to a market participant. To estimate the preliminary fair value of proprietary technology, management used the multi-period excess earnings methodology, which estimates value based on the present value of future economic benefits.

Customer relationships: To estimate the preliminary fair value of customer relationships, which represents a source of repeat business, management applied a single asset utilizing the cost approach, which estimates the value based on the costs necessary to rebuild the existing customer base.

Backlog: To estimate the preliminary fair value of order or production backlog, management used the multi-period excess earnings methodology, which estimates value based on the present value of future economic benefits, based on projected EBITDA levels over the next three years.

The fair value estimate for intangible assets is preliminary and is determined based on the assumptions that market participants would use in pricing similar assets, based on the most advantageous market for the asset (i.e., its highest and best use). This preliminary fair value estimate could include assets that are not intended to be used, may be sold or are intended to be used in a manner other than their best use. For purposes of the accompanying unaudited pro forma condensed combined financial information, it is assumed that all assets will be used in a manner that represents their highest and best use. The final fair value determination for the intangible assets, may differ from this preliminary determination.

The pro forma purchase price allocation presented is for illustrative purposes only and these amounts are not intended to represent or be indicative of the purchase price allocation that would have been reported to give effect to the acquisition as if it had occurred as of the pro forma balance sheet date. The final purchase price allocation could result in a materially different allocation than that presented in these unaudited pro forma condensed combined financial statements. Such adjustments may result in, among other things, an increase or decrease in tangible fixed assets and goodwill and the establishment of intangible assets. If it is ultimately determined that the fair value of acquired assets and liabilities, including any identifiable intangible assets is different, the amount allocated to goodwill may be materiality different. The goodwill of $10.3 million represents the excess of the preliminary estimated purchase consideration over the preliminary fair value of OptaSense's tangible and separately identified intangible assets acquired and liabilities assumed. Goodwill is comprised of the value of intangible assets that do not qualify for separate recognition; for example, expected synergies, income tax savings and other benefits arising from the merger.

4. Financing Adjustments

To finance the Acquisition, the Company borrowed approximately $20.1 million, with the remaining amount of consideration funded using cash on hand for total cash consideration of approximately £29.0 million, approximately $37.4 million using the exchange rate on September 30, 2020 (1.29 $/£).

A Represents an increase in cash and cash equivalents and long-term debt, less current portion, for issuance of term loan and revolving loan borrowings, net of the deferred financing costs of $0.1 million ($0.1 million of which attributed to the Term Note and $0.1 million of which attributed to the Revolving Loan and recognized as a current asset), as described in the Note 2. *Credit Agreement* above.

B Represents the forgiveness of an intercompany loan to the Parent.

Represents the net decrease to interest expense resulting from interest on the new Term Note and Revolving Loan to finance the acquisition of OptaSense and the extinguishment of the existing loan from Parent and the amortization of related debt issuance costs as follows:

	Nine months ended September 30, 2020	Year ended of December 31, 2019
	(in thousands)	
Elimination of interest expense from loan from Parent (i)	$ (908)	$ (2,980)
Interest expense on Term Note and Revolving Loan (ii)	287	469
Amortization of Term Note and Revolving Loan debt issuance costs (iii)	35	57
	$ (586)	$ (2,454)

(i) Represents the elimination of historical interest expense related to the loans from Parent because the outstanding principal amounts of such loans from Parent were not assumed liabilities by the Company.

(ii) In determining pro forma interest expense, the Company used the weighted average interest rate of 2.48% for borrowings used to fund the Acquisition. A hypothetical 1/8 percentage point increase/decrease in the weighted average interest rate used would result in an increase/decrease of approximately $0.02 million in annual pro forma interest expense.

(iii) Represents the estimated amortization of deferred financing costs incurred through the issuance of the New Term Loan and Revolving Loan. See Note 4 *Financing Adjustments*.

C Income tax effects on the financing adjustments were calculated based on the estimated blended statutory income tax rate of 25% for the nine months ended September 30, 2020 and the year ended December 31, 2019, respectively.

5. Purchase Accounting Adjustments

5.1. Unaudited Pro Forma Condensed Combined Balance Sheet Adjustments

D Represents a decrease in cash and cash equivalents of $37.4 million for OptaSense, using the exchange rate as of September 30, 2020. See Note 3, *Preliminary Purchase Price and Preliminary Purchase Price Allocation*, for additional information.

E Represents an $0.4 million adjustment to increase the carrying value of OptaSense's inventory to its estimated acquisition date fair value. As a result of this adjustment, the estimated inventory step-up will increase cost of sales as the acquired inventory is sold within the first turn of inventory after the OptaSense Acquisition. As there is no continuing impact, the effect on cost of sales from the inventory step-up is not included in the unaudited pro forma condensed combined statements of operations.

F To eliminate OptaSense's previously existing intangible assets and to record the preliminary fair value of OptaSense's acquired identifiable intangible assets, including trade names, proprietary technology, customer relationships and backlog. Adjustments to intangible assets consist of the following:

	As of September 30, 2020	
	(in thousands)	
Fair value of acquired intangible assets (i)	$	10,830
Elimination of OptaSense pre-acquisition intangible assets		(2,171)
Pro forma adjustment to intangible assets, net	$	8,659

i. Represents fair value of acquired intangible assets. See Note 3. *Preliminary Purchase Price and Preliminary Purchase Price Allocation.*

G Represents a net adjustment to pro forma goodwill resulting from the preliminary application of acquisition accounting to the assets and liabilities of OptaSense.

H Represents recognition of right of use assets in connection with the entering into a lease agreement with QinetiQ on the Acquisition date, for the office space in Farnborough historically occupied by OptaSense. Prior to the Acquisition, the cost for the office space was allocated by QinetiQ to OptaSense via intercompany cost allocation.

I To accrue for the transaction costs directly related to the Acquisition not yet recognized as of September 30, 2020 with a corresponding decrease to Stockholders' equity. As there is no continuing impact, the effect on operations from transaction costs is not included in the unaudited pro forma condensed combined statements of operations.

J Adjustments to accrued liabilities consist of the following:

	As of September 30, 2020	
	(in thousands)	
Recognition of operating lease liabilities (i)	$	192
Recognition of transaction bonus (ii)		390
Total pro forma adjustment to accrued liabilities	$	582

(i) Represents recognition of $0.2 million of current portion and $0.4 million of long-term operating lease liabilities (balance resides in other long term liabilities) in connection with the entering into a lease agreement with QinetiQ on the Acquisition date, for the office space in

Farnborough historically occupied by OptaSense. Prior to the Acquisition, the cost for the office space was allocated by QinetiQ to OptaSense via intercompany cost allocation.

(ii) Represents adjustment to accrued liabilities for an acquisition bonus of $0.4 million paid to employees of OptaSense subsequently to the acquisition transaction.

K Adjustments reflect accounting for the deferred income tax effects of the purchase accounting adjustments at the estimated blended statutory tax rate of 25%.

L Represents elimination of loan payable to the Parent, which was settled upon the Acquisition and not included in the assumed liabilities by the Company.

M Adjustments to Stockholders' equity consist of the following:

		As of September 30, 2020
		(in thousands)
Elimination of OptaSense's historical equity	$	(17,825)
Transaction costs recognized within retained earnings see **J** above		(2,150)
Total pro forma adjustment to stockholders' equity	$	(19,975)

5.2. Unaudited Pro Forma Condensed Combined Statement of Operations Adjustments

N Adjustment comprised of the following:

		Nine months ended September 30, 2020		Year ended of December 31, 2019
		(in thousands)		
Amortization of intangible assets, net (i)	$	903		1,199
Elimination of pre-acquisition intangible asset amortization (ii)		(668)		(1,216)
Pro Forma adjustment to selling and administrative expenses	$	235	$	(17)

i. Represents increased amortization expense for the fair value of definite lived intangible assets recognized as part of acquisition accounting. Acquired intangible assets are assumed to be amortized on a straightline basis over expected useful lives of 3 - 15 years (see Note 3 *Preliminary Purchase Price and Preliminary Purchase Price Allocation*).

ii. Represents net impact of removal of historical amortization expense.

O Income tax effects on the purchase accounting adjustments were calculated based on the estimated blended statutory income tax rate of 25% for the nine months ended September 30, 2020 and the year ended December 31, 2019, respectively.