CONSOLIDATED FINANCIAL STATEMENTS

Theranos, Inc.
Years Ended December 31, 2008 and 2007
With Report of Independent Auditors

Ernst & Young LLP

ERNST & YOUNG

Theranos, Inc.

Consolidated Financial Statements

Years Ended December 31, 2008 and 2007

Contents

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Report of Independent Auditors

The Board of Directors and Stockholders
Theranos, Inc.

We have audited the accompanying consolidated balance sheets of Theranos, Inc. (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Theranos, Inc. at December 31, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

June 26, 2009,
except for Note 13, as to which the date is
September 9, 2009

Theranos, Inc.

Consolidated Balance Sheets

	December 31 2008	December 31 2007
Assets		
Current assets:		
Cash and cash equivalents	**$ 427,940**	$ 5,536,127
Marketable securities	**1,455,666**	8,972,510
Accounts receivable	**214,621**	–
Prepaid expenses	**250,315**	412,038
Total current assets	**2,348,542**	14,920,675
Property and equipment, net	**2,211,474**	1,795,048
Total assets	**$ 4,560,016**	$ 16,715,723
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	**$ 548,744**	$ 1,683,407
Accrued liabilities	**657,794**	1,802,739
Deferred rent, current portion	**635,955**	5,785
Deferred revenue	**244,399**	500,000
Preferred stock warrant liability	**12,228**	12,228
Total current liabilities	**2,099,120**	4,004,159
Deferred rent	**642,892**	–
Repurchasable shares	**73,000**	28,750
Noncurrent portion of capital lease obligation	**–**	2,937
Total liabilities	**2,815,012**	4,035,846
Commitments and contingencies *(Note 7)*		
Stockholders' equity:		
Common stock, par value $0.0001: 71,773,050 shares authorized; 18,693,775 shares and 17,997,197 shares issued and outstanding at December 31, 2008 and 2007, respectively	**1,869**	1,799
Convertible preferred stock, par value $0.0001: 32,507,950 shares authorized; 31,855,823 shares issued and outstanding, aggregate liquidation preference of $50,109,010	**3,186**	3,186
Additional paid-in capital	**49,920,644**	49,548,404
Accumulated deficit	**(48,183,282)**	(36,889,689)
Accumulated other comprehensive income	**2,587**	16,177
Total stockholders' equity	**1,745,004**	12,679,877
Total liabilities and stockholders' equity	**$ 4,560,016**	$ 16,715,723

See accompanying notes.

Theranos, Inc.

Consolidated Statements of Operations

	Year Ended December 31	
	2008	**2007**
Revenue	**$ 1,798,974**	$ –
Operating expenses:		
Research and development	**10,263,834**	14,389,624
General and administrative	**3,090,802**	3,010,299
Total operating expenses	**13,354,636**	17,399,923
Operating loss	**(11,555,662)**	(17,399,923)
Interest and other income, net	**263,534**	1,132,341
Interest expense	**(1,465)**	(3,290)
Net loss	**$ (11,293,593)**	$ (16,270,872)

See accompanying notes.

Theranos, Inc.

Consolidated Statements of Stockholders' Equity

	Common Stock		Convertible Preferred Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance at December 31, 2006	17,962,700	$ 1,796	31,855,823	$ 3,186	$ 49,413,210	$ (20,618,817)	$ –	$ 28,799,375
Issuance of common stock upon exercise of stock options including vested early exercised shares	203,247	20	–	–	24,458	–	–	24,478
Stock-based compensation	–	–	–	–	110,736	–	–	110,736
Repurchase of restricted shares	(168,750)	(17)	–	–	–	–	–	(17)
Comprehensive loss:								–
Net loss	–	–	–	–	–	(16,270,872)	–	(16,270,872)
Change in net unrealized gain on investments	–	–	–	–	–	–	16,177	16,177
Total comprehensive loss								(16,254,695)
Balance at December 31, 2007	17,997,197	1,799	31,855,823	3,186	49,548,404	(36,889,689)	16,177	12,679,877
Issuance of common stock upon exercise of stock options including vested early exercised shares	**696,578**	**70**	–	–	**174,031**	–	–	**174,101**
Stock-based compensation	–	–	–	–	**194,431**	–	–	**194,431**
Common stock warrants issued for services	–	–	–	–	**3,778**	–	–	**3,778**
Comprehensive loss:								
Net loss	–	–	–	–	–	**(11,293,593)**	–	**(11,293,593)**
Change in net unrealized gain on investments	–	–	–	–	–	–	**(13,590)**	**(13,590)**
Total comprehensive loss								**(11,307,183)**
Balance at December 31, 2008	**18,693,775**	**$ 1,869**	**31,855,823**	**$ 3,186**	**$ 49,920,644**	**$ (48,183,282)**	**$ 2,587**	**$ 1,745,004**

See accompanying notes.

Theranos, Inc.

Consolidated Statements of Cash Flows

	Year Ended December 31 2008	2007
Operating activities		
Net loss	$ **(11,293,593)**	$ (16,270,872)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	**739,605**	672,351
Impairment loss on property and equipment	**10,346**	117,676
Realized gains on investment	**(44,171)**	–
Stock-based compensation	**194,431**	110,736
Common stock warrants issued for services	**3,778**	–
Changes in operating assets and liabilities:		
Accounts receivable	**(214,621)**	–
Prepaid expenses and other assets	**161,723**	74,896
Accounts payable	**(1,134,663)**	(13,194)
Accrued and other liabilities	**(1,137,274)**	644,228
Deferred rent	**1,273,062**	(28,354)
Deferred revenue	**(255,601)**	500,000
Net cash used in operating activities	**(11,696,978)**	(14,192,533)
Investing activities		
Purchases of marketable securities	**(1,931,281)**	(14,605,409)
Proceeds from sales of marketable securities	**3,028,706**	2,999,076
Maturities of investments	**6,450,000**	2,650,000
Purchases of property and equipment	**(1,192,128)**	(956,826)
Change in restricted cash deposits	**–**	100,000
Proceeds from sales of property and equipment	**25,751**	140,355
Net cash provided by (used in) investing activities	**6,381,048**	(9,672,804)
Financing activities		
Payment under capital leases	**(10,608)**	(8,997)
Proceeds from issuance of common stock upon exercise of stock options	**218,351**	48,601
Repurchase of restricted shares	**–**	(17)
Net cash provided by financing activities	**207,743**	39,587
Net decrease in cash and cash equivalents	**(5,108,187)**	(23,825,750)
Cash and cash equivalents at beginning of year	**5,536,127**	29,361,877
Cash and cash equivalents at end of year	$ **427,940**	$ 5,536,127
Supplemental disclosure of cash flow information		
Cash paid for interest	$ **1,465**	$ 3,290

See accompanying notes.

1. Company and Basis of Presentation

Basis of Presentation

Theranos, Inc. (the Company) was incorporated in Delaware in 2004 and is developing the integration of nano- and biotechnologies into real-time informatics systems. The Company is developing monitoring systems that are intended to improve the risk, benefit, and safety profiles of designated therapeutic compounds. The monitoring systems are intended to allow pharmaceutical companies and healthcare professionals to continuously gather and analyze biochemical data while a patient is taking a drug, during clinical trials, and during treatment at home.

In 2008, the Company has generated revenues from validation studies and services provided to customers. For the purposes of presentation and disclosure, the Company was considered to be in the development stage in 2007 and in prior years.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

Reclassifications

Certain amounts from the prior period have been reclassified to conform to the current period presentation. The liability recorded related to shares subject to repurchase from the early exercise of common stock has been reclassified as a long-term liability and the fair value of preferred stock warrants has been reclassified from additional paid-in capital to current liabilities.

Need for Additional Capital

The Company has sustained operating losses since inception and expects such losses to continue at least through 2009. Management believes that cash and marketable securities balances on hand at December 31, 2008, along with the proceeds obtained subsequent to December 31, 2008 (Note 13), will be sufficient to fund planned expenditures at least through March 31, 2010. Management plans to continue to finance the operations with a combination of equity issuances, debt arrangements, and revenue from contracts.

1. Company and Basis of Presentation (continued)

There is no guarantee that such resources will be available to the Company on acceptable terms, if at all, or that such resources will be received in a timely manner, if at all, or that the Company will be able to reduce its expenditures without materially and adversely affecting the business. If adequate funds are not available, the Company may be required to delay, reduce the scope of, or eliminate one or more of its research or development programs. This may affect the Company's ability to continue as a going concern.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity of three months or less from the date of purchase to be cash equivalents.

Marketable Securities

Investments are considered available for sale and are carried at fair market value based on market quotes or pricing models using current market rates. Unrealized gains and losses are reported in stockholders' equity as a separate component of accumulated other comprehensive income (loss). Realized gains and losses are recorded based on the specific-identification method. For the year ended December 31, 2008, the Company recorded realized gains of $44,171 in interest and other income, net. There were no realized gains or losses for the year ended December 31, 2007.

2. Summary of Significant Accounting Policies (continued)

Accounts Receivable

Accounts receivable are recorded net of allowances for doubtful accounts. The allowance for doubtful accounts is calculated based on the Company's assessment of customer credit risk and the application of the specific-identification method. To date, the Company has not recorded a bad debt allowance due to the fact that all of its customers are financially sound companies. The need for a bad debt allowance is evaluated periodically based on the Company's assessment of the creditworthiness of its customers.

Long-Lived Assets

The carrying value of the Company's long-lived assets is reviewed for impairment whenever events or changes in circumstances indicate that the asset may not be recoverable. An impairment loss is recognized when the estimated future consolidated cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. Long-lived assets include property and equipment.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. Estimated lives range from three to five years. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the assets or the term of the lease, whichever is shorter. Amortization of assets under capital leases is included in depreciation expense.

Revenue

The Company entered into various agreements with third parties to conduct system validation studies. Under Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables,* the Company evaluated whether these arrangements contain multiple units of accounting by evaluating whether delivered elements have value on a stand-alone basis and whether there is objective and reliable evidence of the fair value of the undelivered items. The Company concluded that these arrangements consisted of a single unit of accounting, namely, a validation study. Generally, the Company recognizes revenue for these arrangements ratably over the estimated period that the services are rendered to the customer. The performance measure is estimated at the inception of the arrangement and is reevaluated regularly based on study progress and other information that became known during the study. The reevaluation of the performance measures may accelerate or decelerate the recognition of revenue.

2. Summary of Significant Accounting Policies (continued)

The payment terms of these contracts typically include an upfront fee, one or more milestone payments, and/or a final payment. Any revenue recognized in excess of the amount billed to customers is recorded as unbilled revenue and classified as accounts receivable, and any advanced payment received from customers in excess of revenue recognized is recorded as deferred revenue.

The costs associated with the validation study agreements are included in research and development expense.

Stock Compensation

The Company accounts for employee stock options using the fair-value method in accordance with Statement of Financial Accounting Standards (SFAS) No. 123 (revised), *Share-Based Payment*. Stock-based compensation arrangements with nonemployees are accounted for in accordance with SFAS No. 123 (revised) and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services,* using a fair-value approach. The compensation costs of these nonemployee arrangements are generally subject to remeasurement over the vesting terms, as earned.

The Company recognized stock-based compensation expense based on the estimated grant-date fair-value method using the Black-Scholes option-valuation model. The Company is recognizing stock-based compensation expense using a straight-line amortization method. Stock-based compensation expense is recorded based on awards that are ultimately expected to vest, and such expense has been reduced for estimated forfeitures. When estimating forfeitures, the Company considers voluntary termination behaviors as well as trends of the actual option forfeitures.

Research and Development

Research and development costs are expensed as incurred. Research and development costs consist of salaries, employee benefits, and payments to clinical research organizations and other professional service providers. Nonrefundable advance payments for goods and services that will be used or rendered in future research and development activities pursuant to executory contractual arrangements are deferred and recognized as an expense in the period that the related goods are delivered or services are performed.

2. Summary of Significant Accounting Policies (continued)

Income Taxes

The Company utilizes the liability method of accounting for income taxes. Deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax reporting bases of assets and liabilities, and are measured using the enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Currently, there is no provision for income taxes, as the Company has incurred operating losses to date.

Comprehensive Loss

Comprehensive loss is composed of net loss and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized holding gains and losses on the Company's available-for-sale securities. Comprehensive loss for the years ended December 31, 2008 and 2007 is as follows:

	December 31	
	2008	**2007**
Net loss	**$ 11,293,593**	$ 16,270,872
Increase in net unrealized gains on marketable securities	**(30,581)**	(16,177)
Reclassification adjustment for gains on marketable securities recognized in earnings	**44,171**	–
Comprehensive loss	**$ 11,307,183**	$ 16,254,695

3. Cash Equivalents and Marketable Securities

The following is a summary of cash equivalents and marketable securities at December 31, 2008 and 2007:

December 31, 2008	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
U.S. government agency securities	**$ 1,453,079**	**$ 2,587**	**$ –**	**$ 1,455,666**
Money market funds	**50,852**	**–**	**–**	**50,852**
	$ 1,503,931	**$ 2,587**	**$ –**	**$ 1,506,518**
Amounts included in:				
Cash equivalents				**$ 50,852**
Marketable securities – within a year				**1,455,666**
Total cash equivalents and marketable securities				**$ 1,506,518**

December 31, 2007	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
Commercial paper	$ 3,094,120	$ 65	$ (364)	$ 3,093,821
U.S. government agency securities	2,989,051	4,399	–	2,993,450
Corporate notes	2,956,441	14,199	–	2,970,640
Corporate bonds	2,011,442	–	(2,122)	2,009,320
Money market funds	237,918	–	–	237,918
	$ 11,288,972	$ 18,663	$(2,486)	$ 11,305,149
Amounts included in:				
Cash equivalents				$ 2,332,639
Marketable securities – within a year				1,996,290
Marketable securities – within two years				6,976,220
Total cash equivalents and marketable securities				$ 11,305,149

3. Cash Equivalents and Marketable Securities (continued)

The Company reviewed its investment portfolio to identify and evaluate investments that had indications of possible impairment. Factors considered in determining whether a loss is other than temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, the credit quality, and the Company's ability to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value. As of December 31, 2008 and 2007, no instruments in the Company's portfolio have been in an unrealized loss position for more than 12 months.

As of December 31, 2008 and 2007, about $1,456,000 and $1,447,000, respectively, of the cash equivalents and marketable securities balance serve as collateral for an irrevocable letter of credit to secure the lease agreement for the office facility in Palo Alto, California. The collateral will be released upon expiration of the letter of credit.

4. Fair Value Measurements

In September 2006, the Financial Accounting Standards Board (the FASB) issued SFAS No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value, and expands disclosures regarding fair value measurements. The Company adopted the provisions of SFAS 157 for financial assets and liabilities recognized at fair value on a recurring basis on January 1, 2008. The adoption of SFAS 157 did not have a material impact on the Company's consolidated results of operations or financial position.

In February 2008, the FASB issued FASB Staff Position (FSP) No. 157-2 (FSP 157-2), which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. The Company does not believe that the adoption of FSP 157-2 will have a material effect on its consolidated results of operations or financial position.

SFAS 157 defines a three-level valuation hierarchy for disclosure of fair value measurements as follows:

Level 1: Inputs are unadjusted quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2: Inputs (other than quoted market prices included in Level 1) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

4. Fair Value Measurements (continued)

Level 3: Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 and 2007:

December 31, 2008	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
U.S. government agency securities	**$ –**	**$ 1,455,666**	**$ –**	**$ 1,455,666**
Money market funds	**50,852**	**–**	**–**	**50,852**
	$ 50,852	**$ 1,455,666**	**$ –**	**$ 1,506,518**
Liabilities				
Warrants to purchase preferred stock	**$ –**	**$ –**	**$12,000**	**$ 12,000**

December 31, 2007	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Commercial paper	$ –	$ 3,093,821	$ –	$ 3,093,821
U.S. government agency securities	–	2,993,450	–	2,993,450
Corporate notes	–	2,970,640	–	2,970,640
Corporate bonds	–	2,009,320	–	2,009,320
Money market funds	237,918	–	–	237,918
	$ 237,918	$11,067,231	$ –	$11,305,149
Liabilities				
Warrants to purchase preferred stock	$ –	$ –	$12,000	$ 12,000

5. Property and Equipment

Property and equipment consist of the following:

	December 31	
	2008	**2007**
Machinery and equipment	**$ 1,388,097**	$ 1,224,162
Computer equipment	**814,799**	816,461
Office equipment	**15,194**	15,194
Furniture and fixtures	**92,268**	–
Leasehold improvements	**1,639,987**	107,390
Construction in progress	**–**	662,400
	3,950,345	2,825,607
Less accumulated depreciation and amortization	**(1,738,871)**	(1,030,559)
	$ 2,211,474	$ 1,795,048

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company periodically reviews its property and equipment for recoverability whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

During the year ended December 31, 2008, the Company recorded an impairment loss of $10,346 related to write-offs of certain software included in computer equipment, of which $9,036 was recorded in general and administrative expenses and $1,310 was recorded in research and development expenses. During the year ended December 31, 2007, the Company recorded an impairment loss of $117,676, of which $83,120 was recorded in general and administrative expenses related to a write-off of capitalized Web site development costs and $34,556 was recorded in research and development expenses related to write-offs of certain equipment and software.

6. Accrued Liabilities

Accrued liabilities consist of the following:

	December 31	
	2008	**2007**
Accrued compensation	$ **561,478**	$ 560,037
Accrued professional fees	**41,832**	181,974
Other accrued expenses	**54,484**	1,060,728
	$ **657,794**	$ 1,802,739

7. Commitments and Contingencies

Operating Leases

In September 2007, the Company entered into a lease agreement for approximately 32,000 square feet of office space in Palo Alto, California. The lease expiration date is January 31, 2018, with two renewal options for a term of five years each. The Company recognized scheduled rent increases over the lease term, and the landlord allowed the deferral of six months of rent payments from 2008 to be made in a lump sum payment in 2009. Rent expense is recognized on a straight-line basis, resulting in the recognition of a deferred rent liability. The lease is secured by a $1,286,000 irrevocable letter of credit, which is collateralized by cash equivalents and marketable securities of $1,456,000 and a cash balance of $48,000 as of December 31, 2008. The lease provided a tenant improvement allowance of $640,000, which the Company utilized and recorded as deferred rent in 2008. The Company is recognizing the deferred rent as rent expense over the life of the lease term. As additional consideration, the Company granted to the landlord 20,000 Series C convertible preferred stock warrants at a price of $2.82 per share. The warrants are exercisable immediately and expire in 2012. The fair value of the warrants, estimated using the Black-Scholes option-pricing model, was recorded against the deferred rent liability.

7. Commitments and Contingencies (continued)

The Company recognizes rent expense on a straight-line basis over the lease term. Rent expense was $1,226,032 and $447,110 for the years ended December 31, 2008 and 2007, respectively. As of December 31, 2008, future minimum rent payments under operating lease arrangements are as follows:

Year ending December 31:	
2009	$ 1,968,192
2010	1,364,742
2011	1,405,684
2012	1,447,855
2013	1,491,290
Thereafter	6,426,172
	$ 14,103,935

Contingencies

From time to time, the Company may become involved in claims and other legal matters arising in the ordinary course of business. Management is not currently aware of any matters that will have a material adverse effect on the consolidated financial position, results of operations, or cash flows of the Company.

8. Convertible Preferred Stock

Convertible preferred stock consists of:

	December 31, 2008 and 2007				
Series	**Issuance Price per Share**	**Shares Authorized**	**Shares Outstanding**	**Liquidation Preference**	**Carrying Amount**
A	$0.75	9,264,009	9,264,009	$ 6,948,007	$ 5,892,275
B	0.92	10,832,593	10,832,593	10,000,000	9,846,271
C	2.82	12,411,348	11,759,221	33,161,003	33,008,345
		32,507,950	31,855,823	$ 50,109,010	$ 48,746,891

8. Convertible Preferred Stock (continued)

The rights and features of the Company's convertible preferred stock are as follows:

Dividends

Holders of the preferred stock, in preference to the holders of common stock, are entitled to receive dividends, when and as declared by the Board of Directors, but only from funds legally available. No dividends have been declared through December 31, 2008.

Liquidation Preference

In the event of any liquidation, dissolution, or winding up of the Company, either voluntary or involuntary, the holders of the Series C convertible preferred stock are entitled to receive, in preference to any distribution of assets to the holders of Series A convertible preferred stock, Series B convertible preferred stock, or common stock, an amount equal to the original issue price of $2.82 per share for the Series C convertible preferred stock plus all declared and unpaid dividends on the preferred stock. Upon completion of the distribution of the Series C convertible preferred stock liquidation preference, holders of the Series A convertible preferred stock and Series B convertible preferred stock will be entitled to receive, with equal priority and on a pro rata basis, and prior and in preference to any distribution of assets to the holders of common stock, an amount of $0.75 per share and $0.92314 per share for Series A convertible preferred stock and Series B convertible preferred stock, respectively, plus all declared but unpaid dividends on the preferred stock. If upon the liquidation, dissolution, or winding up of the Company the assets of the Company legally available for distribution to the holders of the Series A convertible preferred stock and Series B convertible preferred stock are insufficient to permit the payment as described above, then the entire assets of the Company legally available for distribution shall be distributed first with equal priority and pro rata among the holders of the Series B convertible preferred stock in proportion to the full amounts they would otherwise be entitled to receive, and second with equal priority and pro rata among the holders of the Series A convertible preferred stock in proportion to the full amounts they would otherwise be entitled to receive.

Thereafter, the remaining assets of the Company available for distribution to stockholders shall be distributed among the holders of the Series B convertible preferred stock and the Series C convertible preferred stock and common stock pro rata based on the number of shares of common stock held by each (assuming conversion of all such convertible preferred stock).

8. Convertible Preferred Stock (continued)

Voting

The holders of the Series C convertible preferred stock, voting together as a separate class, are entitled to elect one director of the Company. The holders of the Series B convertible preferred stock, voting together as a separate class, are entitled to elect one director of the Company. The holders of common stock, voting together as a separate class, are entitled to elect one director of the Company. The holders of a majority of the voting power of the convertible preferred stock and the common stock, voting together as a separate class on an as-converted-to-common-stock basis, are entitled to elect up to four additional directors.

Each holder of convertible preferred stock shall be entitled to the number of votes equal to the number of shares of common stock into which the shares of the convertible preferred stock held by such holder could be converted. The holders of the convertible preferred stock shall be entitled to vote on all matters on which the holders of common stock shall be entitled to vote.

Conversion

Each share of Series A, B, and C convertible preferred stock shall be convertible, at the option of the holder thereof, at any time after the date of issuance into shares of common stock at a conversion price of $0.75, $0.92314, and $2.82 per share, respectively. Each share of the convertible preferred stock will be automatically converted into fully paid, nonassessable shares of common stock at the then-effective conversion rate for such share: (i) immediately prior to the closing of a firm commitment, underwritten initial public offering pursuant to an effective consolidated registration statement filed under the Securities Act of 1933, as amended, covering the offer and sale of the Company's common stock, provided that the offering price per share is not less than $5.64 (as adjusted for recapitalizations) and the gross proceeds to the Company are not less than $40,000,000 or (ii) upon the receipt by the Company of a written request for such conversion from the holders of a majority of the convertible preferred stock then outstanding.

9. Restricted Shares

The Company has issued restricted common shares to certain founding employees. The Company has the right to repurchase restricted common shares at the original issue price of $0.0001 per share. The time-based vesting restrictions generally lapse over a period of four years. During the year ended December 31, 2007, 3,001,042 restricted shares were vested and 168,750 restricted shares were repurchased by the Company. There were no restricted shares outstanding as of December 31, 2008 or 2007.

10. 2004 Stock Plan

Under the 2004 Stock Plan, the Company may grant incentive stock options, nonstatutory stock options, and stock purchase rights. All option grants are issued at an exercise price equal to at least 85% of the estimated fair value of common stock, as established by the Board of Directors, on the date of grant, provided that an individual who owns more than 10% of the total combined voting power of all classes of outstanding stock of the Company shall be granted options with a purchase price of at least 110% of the estimated fair value of the common stock on the date of grant. All options vest over periods determined by the Board of Directors, generally up to four years, and expire no more than 10 years after the date of grant. Stock that is purchased prior to the option vesting is subject to the Company's right of repurchase, which lapses over the vesting period. A summary of activity under the 2004 Stock Plan is set forth below:

		Options Outstanding	
	Shares Available for Grant	**Number of Shares**	**Weighted-Average Exercise Price**
Balance at December 31, 2006	2,956,671	3,310,271	
Options granted	(1,464,500)	1,464,500	0.3300
Options canceled	2,085,674	(2,085,674)	0.2235
Options exercised	–	(203,247)	0.1204
Balance at December 31, 2007	3,577,845	2,485,850	
Authorized shares	**4,500,000**	–	
Options granted	**(4,495,350)**	**4,495,350**	**0.3861**
Options canceled	**880,952**	**(880,952)**	**0.2432**
Options exercised	–	**(696,578)**	**0.2499**
Balance at December 31, 2008	**4,463,447**	**5,403,670**	**0.0393**

10. 2004 Stock Plan (continued)

The following table summarizes information concerning outstanding and exercisable options under the 2004 Stock Plan as of December 31, 2008:

	Options Outstanding		Options Exercisable	
Exercise Price	**Number of Options Outstanding**	**Remaining Contractual Life (In Years)**	**Number of Options Exercisable**	**Remaining Contractual Life (In Years)**
$0.0001	10,000	5.96	9,583	5.96
0.0750	174,761	6.38	170,510	6.38
0.1500	458,890	7.31	359,325	7.28
0.3300	482,503	8.40	442,505	8.40
0.3600	1,229,050	9.80	439,911	9.80
0.3960	2,972,966	9.37	2,972,966	9.37
0.4700	75,500	7.85	44,331	7.85
	5,403,670		4,439,131	

Employee stock compensation expense of $153,411 and $75,392 was recorded for the years ended December 31, 2008 and 2007, respectively.

During the years ended December 31, 2008 and 2007, the Company recorded $0 and $14,962, respectively, in stock-based compensation expense due to the accelerated vesting of stock options to certain former employees at the time of termination.

The intrinsic value of options exercised during 2008 and 2007 was $83,691 and $41,485, respectively. The estimated fair value of shares vested during the years ended December 31, 2008 and 2007, was $470,521 and $109,564, respectively. The weighted-average estimated fair value of options granted during the years ended December 31, 2008 and 2007, was $0.22 and $0.21 per share, respectively. The fair value of options granted to employees was estimated using the Black-Scholes method with the following assumptions:

	2008	**2007**
Dividend yield	**0.0%**	0.0%
Expected volatility	**75%**	75%
Risk-free interest rate	**2.8%**	4.4%
Expected term (years)	**5**	5

10. 2004 Stock Plan (continued)

The Company's computation of expected volatility is based on historical volatilities of peer companies. Peer companies' historical volatilities are used in the determination of expected volatility due to the lack of a trading history of the Company's common stock. In selecting the peer companies, the Company considered the following factors: industry, stage of life cycle, size, and financial leverage. The computation of the expected life was based upon peer companies. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant.

During the year ended December 31, 2008, the Company granted options to acquire 1,500 shares of common stock to nonemployees. The Company did not grant options to nonemployees during the year ended December 31, 2007. Stock-based compensation expense of $41,020 and $20,382 was recorded for nonemployee options for the years ended December 31, 2008 and 2007, respectively.

As of December 31, 2008, there was $948,335 of total unrecognized compensation cost related to unvested, share-based compensation arrangements granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 2.11 years.

11. Warrants

In 2008, the Company issued 15,000 common stock warrants at an exercise price of $0.36 each related to services received. The warrants are exercisable immediately and expire in 2015. Using the Black-Scholes option-pricing model, the estimated fair value of the warrants was $3,778, of which $2,519 was expensed to general and administrative expenses and $1,259 was expensed to research and development expenses in 2008.

The Company accounts for the warrants granted under its lease agreement under the provisions of FSP No. 150-5, *Issuer's Accounting under Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares that are Redeemable, an interpretation of SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. Pursuant to FSP No. 150-5, freestanding warrants for shares that are either puttable or warrants for shares that are redeemable are classified as liabilities on the balance sheet at fair value. At the end of each reporting period, changes in fair value during the period are recorded as a component of interest and other income, net. From the date of issuance to December 31, 2008, the change in the fair value of the warrant has not been material. The Company will adjust the liability for changes in fair value until the earlier of the exercise of the warrants, the expiration of the warrants, or the consummation of a liquidation event, including an initial public offering, at which time the liabilities will be reclassified to stockholders' equity when the warrants are converted to common stock warrants.

11. Warrants (continued)

In 2007, the Company issued 20,000 Series C convertible preferred stock warrants at an exercise price of $2.82 each related to a lease agreement. The warrants are exercisable immediately and expire in 2012. The fair value of the warrants, estimated using the Black-Scholes option-pricing model, was $12,228.

12. Income Taxes

As of December 31, 2008 and 2007, the Company has deferred tax assets of approximately $20,500,000 and $15,900,000, respectively. Realization of the deferred tax assets is dependent upon future taxable income, if any, the amount and timing of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. The net valuation allowance increased by approximately $4,500,000 and $6,800,000 during the years ended December 31, 2008 and 2007, respectively. Deferred tax assets primarily relate to net operating loss and tax credit carryforwards.

As of December 31, 2008, the Company has federal and state net operating loss carryforwards of approximately $40,900,000 and $44,600,000, respectively, expiring at various dates beginning in 2014. The Company also has federal and state research and development tax credit carryforwards of approximately $1,600,000 and $1,700,000, respectively. The federal tax credit carryforward will expire beginning in 2024 if not utilized, and the California tax credit carryforward does not expire.

Utilization of the net operating loss and tax credit carryforwards may be subject to substantial annual limitations due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitations may result in the expiration of the net operating losses and credits before their utilization.

13. Subsequent Events

In February 2009, the Company entered into an agreement with Celgene Corporation to provide predictive modeling services and to create a related data infrastructure for consideration of $3,250,000.

In August 2009, the Company entered into a borrowing arrangement under which the Company has now borrowed $8 million. The borrowing is guaranteed by an individual to whom the Company has issued a warrant to purchase 200,000 shares of common stock for $0.36 per share.

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