ITRON INC /WA/
Form 10-Q/A
February 07, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

Amendment No. 1

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from to

Commission file number 000-22418

ITRON, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1011792**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**

2818 North Sullivan Road

Spokane, Washington 99216-1897

(509) 924-9900

(Address and telephone number of registrant s principal executive offices)

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

None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class

Common stock, no par value

Preferred share purchase rights

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes x No ¨

As of July 30, 2004, there were outstanding 20,976,761 shares of the registrant s common stock, no par value, which is the only class of common stock of the registrant.

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EXPLANATORY NOTE

This Amendment No. 1 to our Quarterly Report on Form 10-Q for the three and six months ended June 30, 2004 (the Form 10-Q/A), which was originally filed with the Securities and Exchange Commission on August 4, 2004, is being filed to restate warranty expense as a cost of sales rather than as a cost of services as previously reported. The effect of the restatement on the accompanying condensed consolidated statements of operations is presented in Note 17 to the Company s condensed consolidated financial statements. In addition, as a result of our change in operating segments in the third quarter of 2004, we have restated the information in our segment footnote and revised management s discussion and analysis of financial condition and results of operations to reflect the new segment reporting structure as of September 30, 2004. For purposes of this Form 10-Q/A, and in accordance with Rule 12b-15 under the Securities and Exchange Act of 1934, as amended, the Company has amended and restated Part I, Item 1, Item 2 and Item 4 of the Company s Quarterly Report on Form 10-Q for the three and six months ended June 30, 2004. The other items and disclosures included in this Form 10-Q/A have not been updated for any events subsequent to the previously filed Quarterly Report on Form 10-Q.

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Itron, Inc.

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PART 1: FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS (UNAUDITED)

ITRON, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands, except per share data)			
Revenues				
Sales	$ 68,015	$ 69,941	$ 123,031	$ 133,858
Service	11,627	10,323	22,213	21,051
Total revenues	79,642	80,264	145,244	154,909
Cost of revenues				
Sales (as restated, see Note 17)	37,852	35,326	67,459	67,524
Service (as restated, see Note 17)	5,532	5,584	11,655	11,169
Total cost of revenues	43,384	40,910	79,114	78,693
Gross profit	36,258	39,354	66,130	76,216
Operating expenses				
Sales and marketing	10,272	10,959	19,926	20,289
Product development	10,554	11,042	20,776	20,933
General and administrative	8,652	6,730	15,278	13,877
Amortization of intangibles	2,027	2,765	4,054	4,653
Restructurings	52	43	2,434	2,208
In-process research and development				900
Total operating expenses	31,557	31,539	62,468	62,860
Operating income	4,701	7,815	3,662	13,356
Other income (expense)				
Equity in affiliates	8	30		52
Interest income	111	28	128	197
Interest expense	(2,261)	(929)	(3,015)	(1,385)
Other income (expense), net	(1,009)	(61)	(735)	(36)
Total other income (expense)	(3,151)	(932)	(3,622)	(1,172)

Income before income taxes	1,550	6,883	40	12,184
Income tax (provision) benefit	(732)	(2,710)	40	(5,095)
Net income	$ 818	$ 4,173	$ 80	$ 7,089
Earnings per share				
Basic net income per share	$ 0.04	$ 0.20	$	$ 0.35
Diluted net income per share	$ 0.04	$ 0.19	$	$ 0.33
Weighted average number of shares outstanding				
Basic	20,845	20,372	20,750	20,306
Diluted	22,111	21,765	21,987	21,603

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

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ITRON, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	At June 30, 2004	At December 31, 2003
	(in thousands)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,227	$ 6,240
Accounts receivable, net	61,716	70,782
Inventories	20,357	16,037
Deferred income taxes, net	5,266	11,673
Other	3,854	4,557
Total current assets	93,420	109,289
Property, plant and equipment, net	44,427	42,818
Intangible assets, net	18,925	22,979
Goodwill	90,440	90,385
Restricted cash	128,310	
Deferred income taxes, net	39,345	31,755
Other	9,988	6,263
Total assets	$ 424,855	$ 303,489
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$ 22,824	$ 26,236
Wages and benefits payable	10,920	10,711
Short-term borrowings	21,000	10,000
Current portion of debt	17,435	38,245
Current portion of warranty	7,995	13,939
Unearned revenue	11,240	12,004
Total current liabilities	91,414	111,135
Long-term debt	136,593	
Project financing debt	3,632	4,024
Warranty	3,768	3,536
Other obligations	7,259	7,550
Total liabilities	242,666	126,245
Commitments and contingencies (Notes 7 and 12)		
Shareholders equity		
Preferred stock		
Common stock	205,760	200,567
Accumulated other comprehensive loss	(464)	(136)
Accumulated deficit	(23,107)	(23,187)

Total shareholders equity	182,189	177,244
Total liabilities and shareholders equity	$ 424,855	$ 303,489

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

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ITRON, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six Months Ended June 30,	
	2004	**2003**
	(in thousands)	
Operating activities		
Net income	$ 80	$ 7,089
Non-cash charges (credits) to income:		
Depreciation and amortization	8,830	9,274
Stock option and employee stock purchase plan income tax benefits	1,121	727
Impairment of investments	775	
Equity in affiliates		(52)
Acquired in-process research and development		900
Realized currency translation gain	(279)	
Deferred income tax provision (benefit)	(1,393)	4,769
Other, net	532	644
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	9,066	2,436
Inventories	(4,320)	(358)
Accounts payable, accrued expenses and current portion of warranty	(7,512)	(266)
Wages and benefits payable	209	(7,069)
Unearned revenue	(847)	(4,058)
Long-term warranty and other obligations	24	(5,458)
Other, net	896	673
Cash provided by operating activities	7,182	9,251
Investing activities		
Proceeds from the sale of property, plant and equipment	11	7
Acquisition of property, plant and equipment	(6,830)	(5,460)
Issuance of note receivable		(405)
Acquisitions, net of cash and cash equivalents		(71,077)
Pre-acquisition activities	(4,629)	(684)
Payment of contingent purchase price for RER acquisition	(1,957)	
Other, net	348	104
Cash used by investing activities	(13,057)	(77,515)
Financing activities		
New borrowings	124,081	50,000
Transfer to escrow for senior subordinated notes	(128,310)	
Change in short-term borrowings, net	11,000	
Payments on debt	(8,696)	(4,502)
Issuance of common stock	3,967	2,013
Other, net	(180)	(1,902)
Cash provided by financing activities	1,862	45,609

Decrease in cash and cash equivalents	(4,013)	(22,655)
Cash and cash equivalents at beginning of period	6,240	32,564
Cash and cash equivalents at end of period	$ 2,227	$ 9,909
Non-cash transactions:		
Acquisition of RER, taxes on contingent purchase price payable	$ 113	$
Common stock received in partial settlement of related party note receivable		21

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

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ITRON, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2004

(Unaudited)

In this Report on Form 10-Q/A, the terms we, us, our, Itron and the Company refer to Itron, Inc.

Note 1: Summary of Significant Accounting Policies

Basis of Consolidation

The condensed consolidated financial statements presented in this Form 10-Q/A are unaudited and reflect entries necessary for the fair presentation of the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2004 and 2003, Condensed Consolidated Balance Sheets as of June 30, 2004 and December 31, 2003, and Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and 2003, of Itron and our wholly owned subsidiaries. All such entries are of a normal recurring nature. Inter-company transactions and balances are eliminated upon consolidation. We consolidate all entities in which we have a greater than 50% ownership interest and over which we have control. We account for entities in which we have a 50% or less investment and exercise significant influence under the equity method of accounting. Entities in which we have less than a 20% investment and do not exercise significant influence are accounted for under the cost method. Any variable interest entity of which we are the primary beneficiary is also considered for consolidation. We are not the primary beneficiary of any variable interest entities.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim results. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our Annual Report on Form 10-K/A for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on February 7, 2005. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results expected for the full fiscal year or for any other fiscal period.

Restricted Cash

Restricted cash consists of the net proceeds from the issuance of our $125 million Senior Subordinated Notes (Note 7), as well as our funding of prepaid interest and the notes discount amount, which were held in escrow for the benefit of the holders of the notes pending consummation of our acquisition of the electricity metering products business of Schlumberger Limited (SEM) on July 1, 2004 (Note 16).

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on our historical experience of bad debts and is adjusted for estimated uncollectible amounts.

Inventories

Inventories are stated at the lower of cost or market using the first-in, first-out method. Cost includes raw materials and labor, plus applied direct and indirect costs. Service inventories consist primarily of sub-assemblies and components necessary to support post-sale maintenance. A large portion of our low-volume manufacturing and all of our repair services for our domestic handheld meter reading units are provided by an outside vendor in which we have a 30% equity interest. Consigned inventory at this outside vendor totaled $1.3 million at June 30, 2004 and $538,000 at December 31, 2003, respectively.

Goodwill and Intangible Assets

Goodwill is not amortized and is tested for impairment annually, as of October 1st, or more frequently if a significant event occurs. Intangible assets with a finite life are amortized based on estimated discounted cash flows over estimated useful lives.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Warranty

We offer a one-year standard warranty on most of our hardware products and a three-month standard warranty on most of our software products. An accrual for estimated warranty costs is recorded at the time of sale and periodically adjusted to reflect actual experience. The long-term warranty accrual includes estimated warranty costs for warranties beyond one year. Warranty expense was approximately $1.2 million and $1.8 million for the three months ended June 30, 2004 and 2003, respectively. Warranty expense was approximately $1.5 million and $4.3 million for the six months ended June 30, 2004 and 2003, respectively, and is classified within cost of sales.

A summary of the warranty accrual account activity is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Beginning balance	$ 14,175	$ 10,787	$ 17,475	$ 9,439
Product warranties issued	516	1,515	994	3,298
Adjustments to pre-existing items	662	300	497	956
Utilization of accrual	(3,590)	(1,298)	(7,203)	(2,389)
Ending balance	11,763	11,304	11,763	11,304
Less: current portion of warranty	7,995	6,441	7,995	6,441
Long-term warranty	$ 3,768	$ 4,863	$ 3,768	$ 4,863

Contingencies

An estimated loss for a contingency is charged to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or results of operations.

Revenue Recognition

Sales consist of hardware, software license fee, custom software development, field and project management service and engineering, consulting and installation service revenues. Service revenues include post-sale maintenance support and outsourcing services. Outsourcing services encompass the installation, operation and maintenance of meter reading systems to provide meter information to a customer for billing and management purposes. Outsourcing services can be provided for systems we own as well as those owned by our customers.

Revenue arrangements with multiple deliverables, entered into subsequent to June 30, 2003, are divided into separate units of accounting if the delivered item(s) have value to the customer on a standalone basis, there is objective and reliable evidence of fair value of the undelivered item(s) and delivery/performance of the undelivered item(s) is probable. The total arrangement consideration is allocated among the separate units of accounting based on their relative fair values and the applicable revenue recognition criteria is considered for each unit of accounting. For our standard contract arrangements that combine deliverables such as hardware, meter reading system software, installation and maintenance services, each deliverable is generally considered a single unit of accounting. The amount allocable to a delivered item(s) is limited to the amount that we are entitled to bill and collect and is not contingent upon the delivery/performance of additional item(s).

We generally recognize revenues from hardware at the time of shipment, receipt by customer, or, if applicable, upon completion of customer acceptance provisions. Revenues for software licenses, custom software development, field and project management services, engineering and consulting, installation, outsourcing and maintenance services are recognized when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the sales price is fixed or determinable and (4) collectibility is reasonably assured. For software arrangements with multiple elements, revenue recognition is dependent upon the existence of vendor-specific objective evidence (VSOE) of fair value for each of the elements. The availability of VSOE affects the timing of revenue recognition, which can vary from recognizing revenue at the time of delivery of each element, to the percentage of

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

completion method, or ratably over the performance period. If implementation services are essential to a software arrangement, revenue is recognized using the percentage of completion methodology. Under outsourcing arrangements, revenue is recognized as services are provided. Hardware and software post-contract customer support fees are recognized over the life of related service contracts.

Unearned revenue is recorded for products or services that have not been provided but have been invoiced under contractual agreements or paid for by a customer, or when products or services have been provided but the criteria for revenue recognition have not been met. Unbilled receivables are recorded when revenues are recognized upon product shipment or service delivery and invoicing occurs at a later date.

Earnings Per Share

Basic earnings per share (EPS) is calculated using net income divided by the weighted average common shares outstanding during the period. Diluted EPS is similar to Basic EPS except that the weighted average common shares outstanding are increased to include the number of additional common shares that would have been outstanding if dilutive options had been exercised. Diluted EPS assumes that common shares were issued upon the exercise of stock options for which the market price exceeded the exercise price, less shares that could have been repurchased with the related proceeds (treasury stock method).

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Because of various factors affecting future costs and operations, actual results may differ from estimates.

Stock-Based Compensation

Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation,* allows companies to either expense the estimated fair value of stock options or to continue to follow the intrinsic value method set forth in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, but disclose the pro forma effects on net income had the fair value of the options been expensed. We elected to continue to apply APB No. 25 in accounting for our stock-based compensation plans and disclose the pro forma effects of applying the fair value provisions of SFAS No. 123.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Had the compensation cost for our stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method prescribed in SFAS No. 123, our net income (loss) and net income (loss) per share would have been reduced to the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands, except per share data)			
Net income (loss)				
As reported	$ 818	$ 4,173	$ 80	$ 7,089
Deduct: Total fair value of stock-based compensation expense, net of related tax effect	(1,263)	(1,392)	(2,235)	(2,391)
Pro forma net income (loss)	$ (445)	$ 2,781	$ (2,155)	$ 4,698
Basic earnings per share				
As reported	$ 0.04	$ 0.20	$	$ 0.35
Pro forma	$ (0.02)	$ 0.14	$ (0.10)	$ 0.23
Diluted earnings per share				
As reported	$ 0.04	$ 0.19	$	$ 0.33
Pro forma	$ (0.02)	$ 0.13	$ (0.10)	$ 0.22

The weighted average fair value of options granted was $20.79 and $20.52 during the three months ended June 30, 2004 and 2003, respectively. The weighted average fair value of options granted was $20.50 and $15.64 during the six months ended June 30, 2004 and 2003, respectively. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model using the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Dividend yield				
Expected volatility	72.5%	77.7%	72.8%	76.7%
Risk-free interest rate	4.3%	2.4%	4.0%	2.8%
Expected life (years)	4.5	4.4	4.5	4.9

Volatility measures the amount that a stock price has fluctuated or is expected to fluctuate during a period. The risk-free interest rate is the rate available as of the option date on zero-coupon United States government issues with a remaining term equal to the expected life of the option. The expected life is the weighted average expected life for the entire award based on the fixed period of time between the date the option is granted and the date the option is fully exercised. Factors to be considered in estimating the expected life are the vesting period of the option and the average period of time similar options have remained outstanding in the past.

Reclassifications

Certain amounts in 2003 have been reclassified to conform to the 2004 presentation. As a result of an organizational change, which began in January 2004, and a review of certain operating expenses, we have made some reclassifications between historical sales and marketing, product development and general and administrative expenses in order to conform to the current period presentation.

New Accounting Pronouncement:

On March 31, 2004, the Financial Accounting Standards Board (FASB) ratified the consensus on Emerging Issues Task Force (EITF) 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provides guidance on when an investment is considered impaired, whether that impairment is other than temporary and the measurement of an impairment loss. The guidance also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The provisions of this guidance are applicable to reporting periods beginning after June 15, 2004. We have no investments at June 30, 2004 to which this guidance would apply.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2: Earnings Per Share and Capital Structure

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands, except per share data)			
Basic earnings per share:				
Net income available to common shareholders	$ 818	$ 4,173	$ 80	$ 7,089
Weighted average shares outstanding	20,845	20,372	20,750	20,306
Basic net income per share	$ 0.04	$ 0.20	$	$ 0.35
Diluted earnings per share:				
Net income available to common shareholders	$ 818	$ 4,173	$ 80	$ 7,089
Weighted average shares outstanding	20,845	20,372	20,750	20,306
Effect of dilutive securities - employee stock options	1,266	1,393	1,237	1,297
Adjusted weighted average shares outstanding	22,111	21,765	21,987	21,603
Diluted net income per share	$ 0.04	$ 0.19	$	$ 0.33

We have granted options to purchase shares of our common stock to directors and employees at fair market value on the date of grant.

The dilutive effect of options is calculated using the treasury stock method. Under this method, earnings per share is computed as if the options were exercised at the beginning of the period (or at time of issuance, if later) and as if the funds obtained thereby were used to purchase common stock at the average market price during the period. Weighted average common shares outstanding, assuming dilution, include the incremental shares that would be issued upon the assumed exercise of stock options. At June 30, 2004 and 2003, we had stock options outstanding of approximately 4.0 million and 3.5 million at average option exercise prices of $11.99 and $11.94, respectively. Approximately 397,000 and 445,000 stock options were excluded from the calculation of diluted earnings per share for the three months ended June 30, 2004 and 2003, respectively, because they were anti-dilutive. Approximately 550,000 and 436,000 stock options were excluded from the calculation of diluted earnings per share for the six months ended June 30, 2004 and 2003, respectively, because they were anti-dilutive. These options could be dilutive in future periods.

In November 2002, our Board of Directors authorized the repurchase of up to 1.0 million shares of our common stock. No shares have been repurchased under this repurchase authorization.

In December 2002, we amended and restated our Articles of Incorporation to authorize ten million shares of preferred common stock with no par value. The amendment brings the total number of authorized common and preferred shares to 85 million. In the event of a liquidation, dissolution or winding up of the affairs of the corporation, whether voluntary or involuntary, the holders of the preferred stock at the time outstanding will be entitled to be paid the preferential amount per share to be determined by the Board of Directors prior to any payment to holders of common stock. Shares of preferred stock may be convertible into common stock based on terms, conditions, rates and subject to such adjustments set by the Board of Directors. There was no preferred stock issued or outstanding at June 30, 2004 and December 31, 2003.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3: Certain Balance Sheet Components

	At June 30, 2004	At December 31, 2003
	(in thousands)	
Accounts receivable, net		
Trade (net of allowance for doubtful accounts of $693 and $695)	$ 53,037	$ 62,770
Unbilled revenue	8,679	8,012
Total accounts receivable, net	$ 61,716	$ 70,782
Inventories		
Materials	$ 4,905	$ 4,081
Work in process	660	777
Finished goods	13,579	11,006
Total manufacturing inventories	19,144	15,864
Service inventories	1,213	173
Total inventories	$ 20,357	$ 16,037
Property, plant and equipment, net		
Machinery and equipment	$ 32,221	$ 30,905
Equipment used in outsourcing	16,137	16,093
Computers and purchased software	36,215	33,268
Buildings, furniture and improvements	22,501	21,349
Land	1,735	1,735
Total cost	108,809	103,350
Accumulated depreciation	(64,382)	(60,532)
Property, plant and equipment, net	$ 44,427	$ 42,818

Depreciation expense was $2.3 million and $2.4 million for the three months ended June 30, 2004 and 2003, respectively. Depreciation expense was $4.7 million and $4.6 million for the six months ended June 30, 2004 and 2003, respectively.

The provision to the allowance for doubtful accounts was approximately $73,000 and $162,000 for the three and six months ended June 30, 2004, respectively. There was no provision to increase the allowance for doubtful accounts during the three and six months ended June 30, 2003. There were no recoveries of previously charged-off accounts during the three and six months ended June 30, 2004 or 2003.

Note 4: Business Combinations

Silicon Energy Corp.: On March 4, 2003, we acquired Silicon Energy Corp. (Silicon), a leading provider of enterprise energy management software and services to utilities and large energy users, for consideration equal to $71.1 million in cash, plus other direct transaction costs of approximately $1.3 million, less cash acquired of approximately $1.4 million. Of the consideration, approximately $6.4 million was retained in an indemnification escrow account, which terminates March 2005, to cover certain representations and warranties issued by Silicon. The amount of merger consideration was subject to a working capital adjustment that was finalized within 45 days from closing. No working capital adjustment was required. We acquired Silicon utilizing cash on hand and the proceeds from a $50 million term loan, repayable over three years with equal quarterly principal payments.

At March 4, 2003, Silicon was in the process of developing new software products that had not yet reached technological feasibility. The fair value of the in-process research and development (IPR&D) was estimated using the income approach, which reflects the net present value of the projected cash flows expected to be generated by the products incorporating the in-process technology. The discount rate applicable to the cash flows of the products reflects the stage of completion and other risks inherent in the projects. The discount rate used in the valuation of IPR&D was 29 percent. The fair value of IPR&D was estimated to be $900,000 with an estimated cost to complete of approximately $1.2 million. The in-process technology was substantially completed in 2003. The

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

IPR&D fair value of $900,000 was expensed in March 2003 and recorded within operating expenses. Other identifiable intangible assets with a total value of $14.3 million are being amortized over the lives of the estimated discounted cash flows in the valuation models. Goodwill is assessed for impairment on an annual basis, or upon a significant event during a year, in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*.

The following condensed financial information reflects the allocation of the purchase price based on the fair values of the assets and liabilities.

	Silicon	Useful Life
	(in thousands)	(in months)
Fair value of net assets assumed	$ 12,039	
In-process research and development	900	
Identified intangible assets - amortizable		
Core-developed technology	5,900	28
Customer relationships/contracts	4,400	35
Customer backlog	2,600	13
Trademarks and trade names	200	27
Partner relationships	1,200	14
Goodwill	43,815	
Net assets acquired	$ 71,054	

Goodwill and intangible assets were allocated to our defined reporting units in 2003 based on Silicon s forecasted revenue contribution to each reporting unit.

The following pro forma results for the three and six months ended June 30, 2003 are based on the individual historical results of Itron and Silicon (prior to the acquisition on March 4, 2003) with adjustments to give effect to the combined operations. The adjustments are related to amortization of acquired identified intangible assets, reduction of depreciation expense resulting from adjustments to the value of acquired fixed assets, elimination of interest expense on Silicon s debt, which was paid in full upon acquisition, Silicon s line of credit paid in full and a change in tax provision. The pro forma results are presented solely as supplemental information and do not necessarily represent what the combined results of operations or financial position would actually have been had the transactions in fact occurred at an earlier date, nor are they representative of results for any future date or period.

	Pro Forma
	Six Months Ended
	June 30, 2003
	(in thousands, except

		per share data)
Revenues	$	156,631
Gross profit		75,948
Operating expenses		67,290
Other income (expense)		(1,202)
Net income	$	4,585
Basic net income per share	$	0.23
Diluted net income per share	$	0.21
Weighted average shares assumed outstanding		
Basic		20,306
Diluted		21,603

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5: Identified Intangible Assets

The gross carrying amount and accumulated amortization of our intangible assets, other than goodwill, as of June 30, 2004 and December 31, 2003 were as follows:

	At June 30, 2004			At December 31, 2003		
	Gross Assets	Accumulated Amortization	Net	Gross Assets	Accumulated Amortization	Net
			(in thousands)			
Core-developed technology	$ 18,330	$ (8,062)	$ 10,268	$ 18,330	$ (5,553)	$ 12,777
Patents	7,088	(4,137)	2,951	7,088	(3,952)	3,136
Capitalized software	5,065	(5,065)		5,065	(5,065)	
Distribution and production rights	3,935	(2,851)	1,084	3,935	(2,711)	1,224
Customer contracts	5,650	(1,997)	3,653	5,650	(1,237)	4,413
Other	5,101	(4,132)	969	5,101	(3,672)	1,429
Total identified intangible assets	$ 45,169	$ (26,244)	$ 18,925	$ 45,169	$ (22,190)	$ 22,979

Amortization expense on identified intangible assets was approximately $2.1 million and $2.8 million for the three months ended June 30, 2004 and 2003, respectively. Amortization expense on identified intangible assets was approximately $4.1 million and $4.7 million for the six months ended June 30, 2004 and 2003, respectively. Total amortization expense to be recognized over the remaining six months in 2004 is approximately $4.1 million. Estimated future annual amortization expense is as follows:

Years ending December 31,	Estimated Amortization
	(in thousands)
2005	$ 6,032
2006	3,251
2007	1,893
2008	1,380
Beyond 2008	2,315

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6: Goodwill

We completed our annual impairment test in the fourth quarter of 2003 and concluded that no impairment adjustment was required. Goodwill increased in 2004 due to adjustments to goodwill balances associated with the Silicon and Regional Economic Research, Inc. (RER) acquisitions made during 2003 and 2002. Goodwill increased in 2003 primarily due to the acquisition of Silicon on March 4, 2003 and adjustments to goodwill balances associated with the LineSoft Corporation, RER and eMobile Data Corporation acquisitions made during 2002. In addition, the goodwill balance can increase or decrease, with a corresponding change in other comprehensive income (loss), due to changes in currency exchange rates from the beginning of the period. Goodwill was allocated to our defined reporting units in 2003 based on the forecasted revenue to be contributed to each reporting unit. As a result of our organizational change that began in January 2004, we will reallocate goodwill to our new reporting segments as of October 1, 2004, which is our annual impairment test date. The change in goodwill for the six months ended June 30, 2004 and 2003 is as follows:

	Total Company
	(in thousands)
Goodwill balance at December 31, 2003	$ 90,385
Goodwill adjustments	323
Effect of change in exchange rate	(268)
Goodwill balance at June 30, 2004	$ 90,440
Goodwill balance at December 31, 2002	$ 44,187
Goodwill acquired	41,324
Goodwill adjustments	328
Effect of change in exchange rate	958
Goodwill balance at June 30, 2003	$ 86,797

Note 7: Debt

On March 4, 2003, we entered into a secured credit facility for $105 million and terminated our former $35 million credit line. At June 30, 2004, the secured credit facility was reduced to $84.2 million due to principal payments on the term loan. Collateral that has been granted to the lenders includes equipment, inventory, real property and intellectual property.

The credit facility consists of a $50 million three-year term loan to finance a portion of the Silicon acquisition, which had an outstanding balance of $29.2 million and $37.5 million at June 30, 2004 and December 31, 2003, respectively. The term loan is payable with equal quarterly principal payments. Remaining principal payments under the term loan are $8.3 million in 2004, $16.7 million in 2005 and $4.2 million in 2006. The annual interest rate on the term loan varies according to market rates and our consolidated leverage ratio. The interest rate at June 30, 2004 was 5.75%. Our requirement to enter into an interest rate agreement to substantially fix or limit the interest rate ceased upon repayment in full of the term loan on July 1, 2004.

In addition to the term loan, the credit facility provides a $55 million revolving credit line with a three-year term, which was available for general use at June 30, 2004. Borrowings of $21.0 million and $10.0 million were outstanding on the revolving credit line at June 30, 2004 and December 31, 2003, respectively. The interest rate at June 30, 2004 was 5.75%. At June 30, 2004, $23.0 million of the revolving credit line was utilized by outstanding standby letters of credit resulting in $11.0 million available for additional borrowings.

The credit facility contains financial covenants that require us to maintain certain liquidity and coverage ratios on a quarterly basis. In anticipation of non-compliance with our fixed charge coverage ratio and debt leverage ratio covenant requirements for June 30, 2004, we received waivers of compliance with the covenants from our lenders for June 30, 2004. On July 1, 2004, we replaced this credit facility with a seven-year senior secured term loan as disclosed below, therefore, classification of the long-term portion of our term loan as a current liability was not required at June 30, 2004. At December 31, 2003, our fixed charge coverage ratio covenant was below the minimum required according to our loan agreement. We received waivers of compliance for the December 31, 2003 covenants from our lenders for December 31, 2003. However, at December 31, 2003, we anticipated that we would not be in compliance with all of our loan agreement covenants through 2004, due substantially to a four quarter rolling calculation of a component of our covenant requirements. Consequently, the $20.8 million long-term portion of our term loan was classified as a current liability at December 31, 2003.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In connection with our acquisition of SEM on July 1, 2004, we replaced our current credit facility with $365 million of new debt facilities for a net increase in our debt facilities of approximately $280.8 million. On July 1, 2004, we closed a $240 million senior secured credit facility comprised of a $55 million five-year senior secured revolving credit facility and a $185 million seven-year senior secured term loan. The senior secured term loan is payable in minimum quarterly principal payments of $462,500 for the first six years ($1.85 million annually) and $43,475,000 for each of the quarters in the last year (totaling $173.9 million), not including mandatory prepayments based on excess cash flows, the issuance of capital stock or the sale of assets as defined by the borrowing agreement, which would decrease the minimum monthly payments in the last year. The annual interest rates under the new facility will vary depending on market rates, with initial interest rates based on the London InterBank Offered Rate (LIBOR) plus 2.75%, or the Wells Fargo Bank, National Association s prime rate (Prime) plus 1.75%, for the revolving credit facility and LIBOR plus 2.25%, or Prime plus 1.25%, for the term loan. In addition, debt issuance costs will be amortized over the life of the credit facility. The senior secured credit facility contains financial covenants that require us to maintain certain consolidated leverage and coverage ratios on a quarterly basis, as well as customary covenants, which place restrictions on the incurrence of debt, the payment of dividends, certain investments and mergers. We are also required to enter into an interest rate agreement within 90 days after the closing to substantially fix or limit the interest rate on at least 50% of our aggregate principal amount of debt for a period of not less than three years. At July 1, 2004, approximately 40% of our aggregate principal amount of debt is at fixed rates.

In addition, on May 10, 2004, we completed a private placement of $125 million aggregate principal amount of 7.75% Senior Subordinated Notes, discounted to a price of 99.265 to yield 7.875%, due in 2012. The discount on the Notes will be accreted and the debt issuance costs will be amortized over the life of the credit facility. The net proceeds, as well as our funding of prepaid interest and the notes discount amount, were held in escrow, and were recorded as restricted cash on our balance sheet at June 30, 2004. We placed the notes in advance of the closing of the SEM acquisition in order to lock-in a favorable interest rate. Fixed annual interest will be paid every six months, commencing in November 2004. The notes are subordinated to our new $240 million senior secured credit facility and are guaranteed by all of our operating subsidiaries (except for our foreign subsidiaries and an outsourcing project subsidiary), all of which are wholly owned. The notes contain customary covenants, which place restrictions on the incurrence of debt, the payment of dividends, certain investments and mergers. Some or all of the notes may be redeemed at our option at any time on or after May 15, 2008, at certain specified prices. At any time prior to May 15, 2007, we may, at our option, redeem up to 35% of the notes with the proceeds of certain sales of our common stock.

On July 1, 2004, we used the $124.1 million of gross proceeds from the Senior Subordinated Notes, together with borrowings under our new $240 million senior secured credit facility to finance the acquisition of SEM along with related fees and expenses and to repay outstanding indebtedness of $50.2 million under our previously existing credit facility.

Note 8: Restructurings

In January 2004, we began to implement a change in our organizational structure as we moved from segment reporting based on business units to two operating groups: Hardware Solutions and Software Solutions and we made headcount reductions and other spending adjustments. This restructuring was substantially complete in the first quarter of 2004, with a $52,000 charge recorded in the second quarter of 2004. Restructuring charges of $2.4 million were recorded for the six months ended June 30, 2004.

During the first quarter of 2003, we initiated a restructuring of our Energy Information Systems group located in Raleigh, North Carolina, which included a workforce reduction of approximately 40 employees and recognized a charge of approximately $2.0 million related to severance during 2003. As of March 31, 2003, substantially all of the 40 employees were terminated and severance payments were made. The restructuring was complete in 2003.

In addition, as part of our European operations restructuring, a charge of approximately $216,000 was recorded during the first quarter of 2003 to write-down fixed assets, and approximately $43,000 was recorded during the second quarter of 2003 for additional lease termination charges. The restructuring was complete in 2003.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accrued liabilities associated with Company-wide restructuring efforts were approximately $194,000 and $153,000 at June 30, 2004 and December 31, 2003, respectively and consisted of the following:

	Severance and Related Costs	Lease Termination and Related Costs
	(in thousands)	
Accrual balance at December 31, 2003	$ 28	$ 125
Addition/adjustments to accruals	2,434	51
Cash payments	(2,434)	(10)
Accrual balance at June 30, 2004	$ 28	$ 166
Accrual balance at December 31, 2002	$ 1,263	$ 1,177
Addition/adjustments to accruals	1,961	43
Cash payments	(2,988)	(936)
Accrual balance at June 30, 2003	$ 236	$ 284

The liability for lease terminations is recorded within accrued expenses and the liability for employee severance is recorded within wages and benefits payable. Lease termination and related costs are dependent on our ability to sublease vacant space and are recorded in general and administrative. Restructuring charges are not allocated to our operating segments.

Note 9: Income Taxes

We currently estimate our annual effective income tax rate to be approximately 38% for fiscal year 2004. The expected annual effective income tax rate differs from the federal statutory rate of 35% due to state income taxes, extraterritorial income exclusion tax benefits and changes in valuation allowances.

Our effective income tax rate can vary from period to period due to fluctuations in operating results, changes in valuation allowances for deferred tax assets (which adjust tax assets to an amount that will likely be realized), new or revised tax legislation and changes in the level of business performed in domestic and international tax jurisdictions. The effective income tax rates for the three months ended June 30, 2004 and 2003 were 47% and 39%, respectively. The 2004 quarterly rate was higher than the estimated annual effective income tax rate as a result of the expected expiration of research and development tax credits originally expected to be utilized. A tax benefit is reflected for the six months ended June 30, 2004, due to changes in estimated taxes and valuation allowance adjustments recorded during the interim period financial statements. The effective tax rate for the six months ended June 30, 2003 was 42%. This rate exceeds the statutory rate because there was no tax benefit recognized for the $900,000 IPR&D expense, which is not tax deductible. Excluding the impact of the non-tax deductible IPR&D charge in the first quarter of 2003, the adjusted effective tax rate was 39% for the six months ended June 30, 2003.

Note 10: Long Term Performance Plan

In February 2003, a Long Term Performance Plan (LTPP) for executive officers was established with awards contingent on the attainment of multi-year performance goals designed to drive the long-term financial success and growth of the Company. At the beginning of each performance period, goals and performance objectives are established by the Chief Executive Officer, approved by the Compensation Committee and presented to the Board of Directors. At the end of each performance period, payouts are determined based on actual performance against goals. Payouts will be made in the Company s common stock (50%) and in cash (50%). Business results for the LTPP will be measured over three-year periods with new overlapping award cycles beginning each year. In order to phase in the LTPP, three performance cycles began on January 1, 2003: a one-year cycle, a two-year cycle and a three-year cycle. Thereafter a new three-year cycle will begin on January 1 of each year. Revenue and earnings growth, subject to a performance hurdle of return on capital, were the performance measures used for the first three performance cycles. In future cycles, other measures may be recommended and approved by the Compensation Committee.

An accrual of $150,000 has been recorded for the three and six months ended June 30, 2004 based on an expected achievement of approximately 25% of the performance goals for the two-year cycle that began January 1, 2003. The performance goals for the one-year cycle that began January 1, 2003 were not met and therefore, no payouts were earned for the year ended December 31, 2003.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11: Related Party Transactions

We have a 30% interest in Servatron, Inc. (Servatron), a company that serves both as a contract manufacturer for our low volume products and as our handheld service repair depot. We sublease a portion of our Spokane facility to Servatron. The lease agreement commenced in May 2000 and terminated in May 2004. During the first quarter of 2004, Servatron negotiated a new lease for the period from May 2004 to May 2006. The base monthly lease payments under the new lease are approximately $16,000 and are based on current market rates. Servatron pays us for its share of operating costs of the subleased premises. The costs payable by Servatron to us are based on the square footage of the leased premises.

We lease a facility from former owners of RER, who are now current employees. The lease agreement terminated in December 2003 and was renewed on March 1, 2004 and will terminate in February 2008. The monthly lease expense is approximately $37,000.

During 2003 and 2002, we loaned a total of $2.4 million to Home EcoSystems, Inc., dba Lanthorn Technologies, Inc. (Lanthorn), which was developing internet-based energy monitoring and management software and services. The form of the loans are convertible notes with terms of four to five years, accrue interest at 7% and are convertible at any time into common stock of Lanthorn. If we had converted our notes into equity at June 30, 2004, they would have converted into approximately 22% of Lanthorn s common stock assuming that all granted stock options and other convertible debt of the firm were exercised or converted. We entered into a distribution and licensing agreement with Lanthorn, which gave us non-exclusive distribution and licensing rights. Lanthorn has not produced any significant revenue.

In December 2003, due to consideration of the estimated fair market value of Lanthorn as indicated by Lanthorn s last round of financing, we recorded a $1.9 million impairment to the loans and accrued interest, which consisted of a $176,000 reversal of interest income recognized in the first three quarters of 2003 and a $1.7 million charge to other income (expense), net, for the principal. During the second quarter of 2004, we recorded an additional impairment of $775,000 to other income (expense), net, for the remaining loan balance and accrued interest as Lanthorn substantially ceased operations in May 2004. At June 30, 2004, there was no remaining net loan or accrued interest balances. At December 31, 2003, the loan balances were included within other noncurrent assets.

During 2003, an officer of one of our customers held a position on our Board of Directors. During the second quarter of 2004, this individual resigned from our Board of Directors.

Note 12: Commitments and Contingencies

Guarantees and Indemnifications

Under Financial Accounting Standards Board Interpretation 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we record a liability for certain types of guarantees and indemnifications for agreements entered into or amended subsequent to December 31, 2002. No liabilities were required for agreements entered into during the six

months ended June 30, 2004.

We maintain bid and performance bonds for certain customers. Bonds in force were $6.8 million and $41.7 million at June 30, 2004 and December 31, 2003, respectively. Bid bonds guarantee that we will enter into a contract consistent with the terms of the bid. Performance bonds provide a guarantee to the customer for future performance, which usually covers the installation phase of a contract and may on occasion cover the operations and maintenance phase of outsourcing contracts.

We also have standby letters of credit to guarantee our performance under certain contracts. The outstanding amounts of standby letters of credit were $23.0 million and $15.0 million at June 30, 2004 and December 31, 2003, respectively.

We generally provide an indemnification related to the infringement of any patent, copyright, trademark or other intellectual property right on software or equipment within our sales contracts, which indemnifies the customer from and pays the resulting costs, damages and attorney fees awarded against a customer with respect to such a claim provided that (a) the customer promptly notifies us in writing of the claim and (b) we have the sole control of the defense and all related settlement negotiations. The terms of the indemnification normally do not limit the maximum potential future payments. We also provide an indemnification for third party claims resulting from damages caused by the negligence or willful misconduct of our employees/agents in connection with the performance of certain contracts. The terms of the indemnification generally do not limit the maximum potential payments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Legal Matters

We are subject to various legal proceedings and claims of which the outcomes are subject to significant uncertainty. Our policy is to routinely assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the reserves required, if any, for these contingencies is made after thoughtful analysis of each known issue in accordance with SFAS No. 5, *Accounting for Contingencies*, and related pronouncements. Reserves are recorded when we determine that a loss is probably, or likely to occur, and the amount can be reasonably estimated. At June 30, 2004, we determined that no such losses were probable. However, we identified one matter for which a loss was reasonably possible but less than probable. We have estimated the range for possible loss in this matter to be between zero and $700,000, however, in accordance with SFAS No. 5, no liability has been recorded.

Note 13: Segment Information

In January 2004, we began to implement an organizational change that resulted in a change in our segment reporting from five market facing business units (Electric, Natural Gas, Water & Public Power, International and End User Solutions) to two operating groups (Hardware Solutions and Software Solutions). In July 2004, we made additional refinements to our operating groups. The segment information in this Form 10-Q/A is based on the new segment reporting structure. Accordingly, historical segment information in this Form 10-Q/A has been restated to reflect the new reporting structure.

Management has three primary measures for each of the operating groups: revenue, gross margin and operating income. Revenues for each operating group are according to product lines. There are no inter-operating group revenues. Within each operating group, costs of sales include materials, direct labor, warranty expense, an overhead allocation and variances from standard costs. Service related cost of sales are based on actual time and materials incurred and an allocation of miscellaneous service related costs. Operating expenses directly associated with each operating group may include sales, marketing, product development or administrative expenses.

Corporate operating expenses, interest revenue, interest expense, equity in the income of investees accounted for by the equity method, amortization expense and income tax expense are not allocated to the operating groups, nor included in the measure of segment profit or loss. Assets and liabilities are not allocated to the operating groups. Approximately 50% of depreciation expense is allocated to the operating groups.

Operating Segment Products

Operating Segment	Major Products
Hardware Solutions:	Residential and commercial automatic meter reading (AMR) retrofit and OEM (original equipment manufacturer) modules, mobile and network AMR data collection technologies, SmartSynch meter systems, handheld computers for meter data collection or mobile workforce applications, and related installation and implementation services.
Software Solutions:	Software applications for commercial, industrial and residential meter data collection and management, distribution system design and optimization, energy and water management, asset optimization, mobile workforce solutions, and

forecasting and related implementation, forecasting and consulting services.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Operating Segment Information

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Revenues				
Hardware Solutions	$ 67,170	$ 68,413	$ 121,916	$ 130,640
Software Solutions	12,472	11,851	23,328	24,269
Total Company	$ 79,642	$ 80,264	$ 145,244	$ 154,909
Gross profit				
Hardware Solutions	$ 31,309	$ 36,159	$ 58,086	$ 68,728
Software Solutions	4,949	3,195	8,044	7,488
Total Company	$ 36,258	$ 39,354	$ 66,130	$ 76,216
Operating income (loss)				
Hardware Solutions	$ 25,744	$ 30,047	$ 47,519	$ 56,998
Software Solutions	(3,570)	(5,455)	(9,165)	(11,637)
Corporate unallocated	(17,473)	(16,777)	(34,692)	(32,005)
Total Company	4,701	7,815	3,662	13,356
Total other income (expense)	(3,151)	(932)	(3,622)	(1,172)
Income before income taxes	$ 1,550	$ 6,883	$ 40	$ 12,184

One customer accounted for approximately 11% of total Company revenues for the three and six months ended June 30, 2004 and 14% and 13% of Hardware Solutions revenues for the three and six months ended June 30, 2004, respectively. There was no customer that represented greater than 10% of Software Solutions revenues for the three and six months ended June 30, 2004.

Another customer and its subsidiaries accounted for approximately 11% of total Company revenues for the three and six months ended June 30, 2003, and 13% and 12% of Hardware Solutions revenues during the three and six months ended June 30, 2003, respectively. One customer represented 14% of Software Solutions revenues for the six months ended June 30, 2003, respectively.

Note 14: Comprehensive Income (Loss)

Comprehensive income adjustments are reflected as an increase or (decrease) to shareholders equity and are not reflected in results of operations. Operating results adjusted to reflect comprehensive income items during the period, net of tax, were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Net income	$ 818	$ 4,173	$ 80	$ 7,089
Change in foreign currency translation adjustments, net of tax	(100)	476	(328)	878
Total comprehensive income (loss)	$ 718	$ 4,649	$ (248)	$ 7,967

Accumulated foreign currency translation adjustment was the sole component of accumulated other comprehensive income (loss), net of tax, at June 30, 2004 and December 31, 2003. The accumulated other comprehensive loss, net of tax, was approximately $(464,000) and $(136,000) at June 30, 2004 and December 31, 2003, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 15: Condensed Consolidating Financial Information

The Senior Subordinated Notes are guaranteed by all of our operating subsidiaries (except for our foreign subsidiaries and an outsourcing project subsidiary), all of which are wholly-owned. The guarantees are joint and several, full, complete and unconditional. There are currently no restrictions on the ability of the subsidiary guarantors to transfer funds to the parent company. The following condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered. The following information gives affect to the restatement described in Note 17.

We have three wholly owned domestic guarantor subsidiaries, which were established for various business purposes. Two of these subsidiaries have no assets or operations. The third subsidiary held $7.1 million and $7.0 million of an investment in a non-guarantor subsidiary at June 30, 2004 and December 31, 2003, respectively. The net income (loss) from this investment was ($4,000) and $72,000 for the three and six months ended June 30, 2004, respectively, and $66,000 and $98,000 for the three and six months ended June 30, 2003, respectively. The guarantor subsidiary s investment in and results of operations from the non-guarantor subsidiary are shown within the Combined Parent and Guarantor Subsidiaries column.

Condensed Consolidating Statement of Operations

Three Months Ended June 30, 2004

	Combined Parent and Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Consolidated
		(in thousands)		
Revenues				
Sales	$ 67,042	$ 1,183	$ (210)	$ 68,015
Service	10,536	1,789	(698)	11,627
Total revenues	77,578	2,972	(908)	79,642
Cost of revenues				
Sales	37,570	492	(210)	37,852
Service	4,767	1,480	(715)	5,532
Total cost of revenues	42,337	1,972	(925)	43,384
Gross profit	35,241	1,000	17	36,258
Operating expenses				

Sales and marketing	9,574	698		10,272
Product development	10,609	(72)	17	10,554
General and administrative	8,373	279		8,652
Amortization of intangibles	2,027			2,027
Restructurings	52			52
Total operating expenses	30,635	905	17	31,557
Operating income	4,606	95		4,701
Other income (expense)				
Equity in affiliates	8			8
Interest income	209	2	(100)	111
Interest expense	(2,172)	(189)	100	(2,261)
Other income (expense), net	(882)	(127)		(1,009)
Total other income (expense)	(2,837)	(314)		(3,151)
Income (loss) before income taxes	1,769	(219)		1,550
Income tax provision	(563)	(169)		(732)
Equity in earnings (losses) of non-guarantor subsidiaries	(388)		388	
Net income (loss)	$ 818	$ (388)	$ 388	$ 818

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statement of Operations

Three Months Ended June 30, 2003

	Combined Parent and Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Consolidated
		(in thousands)		
Revenues				
Sales	$ 69,047	$ 924	$ (30)	$ 69,941
Service	9,486	1,630	(793)	10,323
Total revenues	78,533	2,554	(823)	80,264
Cost of revenues				
Sales	34,877	479	(30)	35,326
Service	5,022	1,244	(682)	5,584
Total cost of revenues	39,899	1,723	(712)	40,910
Gross profit	38,634	831	(111)	39,354
Operating expenses				
Sales and marketing	10,466	517	(24)	10,959
Product development	11,027	98	(83)	11,042
General and administrative	6,734		(4)	6,730
Amortization of intangibles	2,765			2,765
Restructurings		43		43
Total operating expenses	30,992	658	(111)	31,539
Operating income	7,642	173		7,815
Other income (expense)				
Equity in affiliates	30			30
Interest income	154	49	(175)	28
Interest expense	(878)	(226)	175	(929)
Other income (expense), net	(185)	124		(61)
Total other income (expense)	(879)	(53)		(932)
Income before income taxes	6,763	120		6,883
Income tax provision	(2,620)	(90)		(2,710)
Equity in earnings (losses) of non-guarantor subsidiaries	30		(30)	

Net income	$ 4,173	$ 30	$ (30)	$ 4,173

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statement of Operations

Six Months Ended June 30, 2004

	Combined Parent and Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Consolidated
		(in thousands)		
Revenues				
Sales	$ 121,661	$ 1,713	$ (343)	$ 123,031
Service	20,141	3,662	(1,590)	22,213

Current assets:

Cash and cash equivalents	$ 30,042,986	$ 9,759,169
Marketable securities, current	4,181,592	26,696,413
Other receivables	164,204	264,631
Note receivable	298,032	1,000,000
Prepaid assets	645,242	1,032,482
Total current assets	35,332,056	38,752,695
Marketable securities, non current		3,150,971
Property, plant and equipment, net	3,173,468	3,905,404
Other assets, non-current	2,079,278	1,710,829
Intangible assets, net	645,538	762,667
Total assets	$ 41,230,340	$ 48,282,566

LIABILITIES AND STOCKHOLDERS EQUITY

Current liabilities:		
Accounts payable	$ 1,078,123	$ 1,813,595
Accrued expenses and other liabilities	2,261,245	2,462,252
Accrued wind-down expenses, current	1,420,378	1,374,632
Deferred revenue, current	43,909	43,909
Capital lease obligation, current	18,739	17,530
Deferred rent, current	346,930	290,391
Bonds payable, current	149,167	136,250
Total current liabilities	5,318,491	6,138,559

Capital lease obligation, non-current	6,529	25,269
Bonds payable, non-current	860,000	1,009,166
Fair value of warrant liability	8,439,931	
Deposits and other long-term liabilities	466,211	527,804
Accrued wind-down expenses, non-current	4,092,939	4,768,859
Deferred rent, non-current	90,215	437,144
Deferred revenue, non-current	147,039	163,865
Total liabilities	19,421,355	13,070,666
Commitments and contingencies (Note 9)		
Stockholders equity:		
Common stock, $.01 par value; 250,000,000 shares authorized; issued and outstanding 94,945,603 at December 31, 2008 and 80,681,087 at December 31, 2007	949,455	806,810
Additional paid-in capital	279,868,802	264,603,711
Accumulated deficit	(259,001,524)	(229,914,747)
Accumulated other comprehensive loss	(7,748)	(283,874)
Total stockholders equity	21,808,985	35,211,900
Total liabilities and stockholders equity	$ 41,230,340	$ 48,282,566

See Notes to Consolidated Financial Statements.

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StemCells, Inc.

Consolidated Statements of Operations

	Year Ended December 31, 2008	2007	2006
Revenue:			
Revenue from licensing agreements and grants	$ 231,730	$ 56,722	$ 92,850
Operating expenses:			
Research and development	17,808,009	19,937,426	13,600,433
General and administrative	8,295,554	7,927,443	7,154,042
Wind-down expenses	866,199	783,022	709,209
Total operating expenses	26,969,762	28,647,891	21,463,684
Operating loss	(26,738,032)	(28,591,169)	(21,370,834)
Other income (expense):			
License and settlement agreement, net		550,467	103,359
Realized gain on sale of marketable securities		715,584	
Other than temporary impairment of marketable securities	(2,082,894)		
Change in fair value of warrant liability	(937,241)		
Interest income	803,095	2,459,820	2,479,740
Interest expense	(109,762)	(123,606)	(143,001)
Other expense, net	(21,943)	(33,898)	(17,644)
Total other income (expense), net	(2,348,745)	3,568,367	2,422,454
Net loss	$ (29,086,777)	$ (25,022,802)	$ (18,948,380)
Basic and diluted net loss per share	$ (0.35)	$ (0.31)	$ (0.25)
Shares used to compute basic and diluted loss per share	82,716,455	79,772,351	74,611,196

See Notes to Consolidated Financial Statements.

StemCells, Inc.

Consolidated Statements of Stockholders Equity

	Common Stock		Additional Paid-in	Accumulated	Accumulated Other Comprehensive Income	Total Stockholders
	Shares	**Amount**	**Capital**	**Deficit**	**(Loss)**	**Equity**
Balances, December 31, 2005	65,396,022	$ 653,960	$ 217,919,336	$ (185,943,565)	$ (254,147)	$ 32,375,584
Comprehensive loss						
Net loss				(18,948,380)		(18,948,380)
Change in unrealized gain on securities available-for-sale					3,442,125	3,442,125
Comprehensive loss						(15,506,255)
Issuance of common stock related to equity financing net of issuance cost of $2,418,467	11,750,820	117,508	33,304,026			33,421,534
Common stock issued for licensing agreements	3,848	38	9,962			10,000
Common stock issued pursuant to employee benefit plan	50,120	501	121,955			122,456
Compensation expense from grant of options and stock (fair value)			2,409,509			2,409,509
Exercise of employee and consultant stock options	319,094	3,191	545,088			548,279
Exercise of warrants	526,400	5,264	989,632			994,896
Balances, December 31, 2006	78,046,304	780,462	255,299,508	(204,891,945)	3,187,978	54,376,003
Comprehensive loss						
Net loss				(25,022,802)		(25,022,802)

Change in unrealized loss on securities available-for-sale					(3,471,852)	(3,471,852)
Comprehensive loss						(28,494,654)
Issuance of common stock related to equity financing net of issuance cost of $297,465	1,807,000	18,070	4,816,983			4,835,053
Common stock issued for licensing agreements	3,865	39	9,961			10,000
Common stock issued pursuant to employee benefit plan	73,074	731	172,429			173,160
Compensation expense from grant of options and stock (fair value)			3,008,315			3,008,315
Exercise of employee stock options	175,186	1,752	208,521			210,273
Exercise of warrants	575,658	5,756	1,087,994			1,093,750
Balances, December 31, 2007	80,681,087	806,810	264,603,711	(229,914,747)	(283,874)	35,211,900
Comprehensive loss						
Net loss				(29,086,777)		(29,086,777)
Change in unrealized loss on securities available-for-sale					276,126	276,126
Comprehensive loss						(28,810,651)
Issuance of common stock and warrants, net of issuance cost of $1,432,539	13,998,704	139,987	11,184,188			11,324,175
Common stock issued for licensing agreements	6,924	69	9,931			10,000
Common stock issued pursuant to employee benefit plan	144,188	1,442	189,724			191,166
Compensation expense from grant of options, restricted			3,754,871			3,754,871

stock units and stock (fair value)						
Exercise of employee and director stock options	114,700	1,147	126,377			127,524
Balances, December 31, 2008	94,945,603	$ 949,455	$ 279,868,802	$ (259,001,524)	$ (7,748)	$ 21,808,985

See Notes to Consolidated Financial Statements.

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StemCells, Inc.

Consolidated Statements of Cash Flows

	Year Ended December 31,		
	2008	**2007**	**2006**
Cash flows from operating activities:			
Net loss	$ (29,086,777)	$ (25,022,802)	$ (18,948,380)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,186,428	1,174,510	1,044,688
Issue of shares and options in exchange for services	3,946,037	3,181,475	2,531,966
(Gain) loss on disposal of fixed assets		(1,500)	1,573
Non-cash income from license and settlement agreement, net		(550,467)	(103,359)
Gain on sale of marketable securities		(715,584)	
Other than temporary impairment of marketable securities	2,082,894		
Change in fair value of warrant liability	937,241		
Changes in operating assets and liabilities:			
Other receivables	100,427	218,219	(280,931)
Prepaid assets	387,240	86,985	(732,501)
Other assets, net	(358,449)	19,532	56,270
Accounts payable and accrued expenses	(936,479)	1,601,180	554,245
Accrued wind-down expenses	(630,174)	(606,766)	(555,469)
Deferred revenue	(16,826)	10,257	197,517
Deferred rent	(290,390)	(232,198)	105,735
Deposits and other long-term liabilities	(61,593)	(19,587)	24,526
Net cash used in operating activities	(22,740,421)	(20,856,746)	(16,104,120)
Cash flows from investing activities:			
Purchase of marketable debt securities	(4,822,684)	(37,029,744)	
Sales or maturity of marketable debt securities	28,681,708	9,168,183	
Proceeds from sale of marketable equity securities		3,074,654	
Repayment received under note receivable	1,000,000		
Advance made under note receivable	(298,032)	(1,000,000)	
Purchases of property, plant and equipment	(312,988)	(1,319,374)	(1,258,749)
Purchase of intangibles and other assets	(24,375)	(49,375)	(38,375)
Net cash provided by (used in) investing activities	24,223,629	(27,155,656)	(1,297,124)
Cash flows from financing activities:			
Proceeds from issuance of common stock, net	18,826,865	4,835,053	33,421,534
Proceeds from the exercise of stock options	127,524	210,273	548,279
Proceeds from the exercise of warrants		1,093,750	994,896

Proceeds (repayments) of capital lease obligations	(17,531)	42,799	(54,676)
Repayments of bonds payable	(136,249)	(205,833)	(254,168)
Net cash provided by financing activities	18,800,609	5,976,042	34,655,865
Increase (decrease) in cash and cash equivalents	20,283,817	(42,036,360)	17,254,621
Cash and cash equivalents at beginning of year	9,759,169	51,795,529	34,540,908
Cash and cash equivalents at end of the year	$ 30,042,986	$ 9,759,169	$ 51,795,529
Supplemental disclosure of cash flow information:			
Interest paid	$ 109,762	$ 123,606	$ 143,001
Supplemental schedule of non-cash investing and financing activities:			
Stock issued for licensing agreements(1)	$ 10,000	$ 10,000	$ 10,000

(1) Under terms of a license agreement with the California Institute of Technology (Cal Tech), annual fees of $5,000 were due on each of two patents to which StemCells holds a license from Cal Tech, payable in cash or stock at our choice. We elected to pay the fees in common stock and issued shares of 6,924 in 2008, 3,865 in 2007 and 3,848 in 2006 to Cal Tech.

See Notes to Consolidated Financial Statements.

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StemCells, Inc.

Notes to Consolidated Financial Statements
December 31, 2008

Note 1. Summary of Significant Accounting Policies

Nature of Business

StemCells, Inc., a Delaware corporation, is a biopharmaceutical company that operates in one segment, the development of novel cell-based therapeutics designed to treat human diseases and disorders.

The accompanying consolidated financial statements have been prepared on the basis that we will continue as a going concern. Since inception, we have incurred annual losses and negative cash flows from operations and have an accumulated deficit of approximately $259 million at December 31, 2008. We have not derived revenue from the sale of products, and do not expect to receive revenue from product sales for at least several years. We may never be able to realize sufficient revenue to achieve or sustain profitability in the future.

We expect to incur additional operating losses over the foreseeable future. We have limited liquidity and capital resources and must obtain significant additional capital and other resources in order to sustain our product development efforts, to provide funding for the acquisition of technologies and intellectual property rights, preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, general and administrative expenses and other working capital requirements. We rely on our cash reserves, proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, government grants and funding from collaborative arrangements, to fund our operations. If we exhaust our cash reserves and are unable to obtain adequate financing, we may be unable to meet our operating obligations and we may be required to initiate bankruptcy proceedings. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Principles of Consolidation

The consolidated financial statements include the accounts of StemCells, Inc., and our wholly owned subsidiary, StemCells California, Inc. Material intercompany accounts and transactions have been eliminated.

Use of Estimates

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

Significant estimates include the following:

Accrued wind-down expenses (See Note 8).

The fair value of share-based awards recognized as compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004) Share Based Payment (SFAS 123R). (See Note 7).

Valuation allowance against net deferred tax assets (See Note 14).

The fair value of warrants recorded as a liability in accordance with Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company s Own Stock* EITF 00-19. The warrants were issued as part of our November 2008 financing (See Note 10).

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Financial Instruments

Cash Equivalents and Marketable Securities

All money market and highly liquid investments with a maturity of 90 days or less at the date of purchase are classified as cash equivalents. Highly liquid investments with maturities of 365 days or less not previously classified as cash equivalents are classified as marketable securities, current. Investments with maturities greater than 365 days are classified as marketable securities, non-current. Our marketable debt and equity securities have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments in marketable debt and equity securities at the time of purchase and reevaluates the available-for-sale designations as of each balance sheet date. These securities are carried at fair value (see Note 2, Financial Instruments, below), with the unrealized gains and losses reported as a component of stockholders equity. The cost of securities sold is based upon the specific identification method.

If the estimated fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery to the cost of the investment, and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. Other-than-temporary declines in estimated fair value of all marketable securities are charged to other income (expense), net. After considering various criteria, including the duration of the impairment and our intent to liquidate all or part of our investment within a reasonably short period of time, we determined that the impairment of our investment in ordinary shares of ReNeuron (marketable equity securities) (see Note 2, Financial Instruments, below), was other than temporary. For the year ended December 31, 2008, we recorded on our Consolidated Statements of Operations under Other Income (expense) a loss of $2,082,894, which is the difference between the investment s carrying value and its quoted market price at that date. No other than temporary impairment was recognized during the years ended December 31, 2007 and 2006.

Other Receivables

Our non-trade receivables generally consist of interest income on our financial instruments, revenue from licensing agreements and rent from our sub-lease tenants.

Estimated Fair Value of Financial Instruments

The estimated fair value of cash and cash equivalents, other receivables, accounts payable and the current portion of the bonds payable approximates their carrying values due to the short maturities of these instruments. The estimated fair value of our marketable debt securities approximates its carrying value based on current rates available to us for similar debt securities.

Property, Plant and Equipment

Property, plant, and equipment, including those held under capital lease, are stated at cost. Depreciation is computed by use of the straight-line method over the estimated useful lives of the assets, or the lease term if shorter, as follows:

Building and improvements	3 - 20 years
Machinery and equipment	3 - 10 years
Furniture and fixtures	3 - 10 years

Repairs and maintenance costs are expensed as incurred.

Intangible Assets (Patent and License Costs)

Prior to fiscal year 2001, we capitalized certain patent costs, which are being amortized over the estimated life of the patent and would be expensed at the time such patents are deemed to have no continuing value. Since 2001, all

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

patent costs are expensed as incurred. License costs are capitalized and amortized over the estimated life of the license agreement.

Impairment of Long-Lived Assets

We review property, plant, and equipment and certain identifiable intangibles for impairment in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparing the carrying amount to future undiscounted cash flows the assets are expected to generate. If property, plant, and equipment and patents are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its estimated fair market value. No such impairment was recognized during the years ended December 31, 2008, 2007 and 2006.

Warrant Liability

We account for our warrants in accordance with EITF 00-19, which defines how freestanding contracts that are indexed to and potentially settled in a company s own stock should be measured and classified. The general concept under EITF 00-19 is that contracts that could require net-cash settlement should be classified as assets or liabilities and contracts that only provide for settlement in shares should be classified as equity. In order for a contract to be classified as equity, each of the specific conditions enumerated in EITF 00-19 must be met; these conditions are intended to identify situations in which net cash settlement could be forced upon the issuer. As part of our November 2008 financing, we issued warrants with a five year term to purchase 10,344,828 shares of our common stock at $2.30 per share. In accordance with EITF 00-19, we are required to classify the fair value of the warrants issued as a liability, with subsequent changes in fair value to be recorded as income (loss) on change in fair value of warrant liability. The fair value of the warrants is determined using the Black-Scholes-Merton (Black-Scholes) option pricing model and is affected by changes in inputs to that model including our stock price, expected stock price volatility and contractual term. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability.

Revenue Recognition

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property. Such licensing agreements may contain multiple elements, such as up-front fees, payments related to the achievement of particular milestones and royalties. Revenue from up-front fees for licensing agreements that contain multiple elements are generally deferred and recognized on a straight-line basis over the term of the agreement. Fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned. Revenue from collaborative agreements and grants are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the relevant collaborative agreement or grant.

Research and Development Costs

Our research and development expenses consist primarily of salaries and related personnel expenses, costs associated with clinical trials and regulatory submissions; costs associated with preclinical activities such as toxicology studies; certain patent-related costs such as licensing; facilities-related costs such as depreciation; lab equipment and supplies. Clinical trial expenses include payments to vendors such as clinical research organizations,

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

contract manufacturers, clinical trial sites, laboratories for testing clinical samples and consultants. All research and development costs are expensed as incurred.

Stock-Based Compensation

On January 1, 2006, we adopted SFAS No. 123 (revised 2004) (SFAS 123R), *Share-Based Payment,* SFAS 123R requires us to expense the fair value of our stock-based compensation awards to employees. We apply SFAS 123R to new awards, as well as to awards that vest, are modified, repurchased, or cancelled after the date of adoption. The compensation cost we record for these awards are based on their grant-date fair value as calculated and amortized over their vesting period. See Note 7, Stock-Based Compensation for further information.

We account for stock options granted to non-employees in accordance with SFAS 123 and Emerging Issues Task Force (EITF) 96-18 *Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring, Or In Conjunction With Selling, Goods Or Services*, and accordingly, expense the estimated fair value of such options as calculated using the Black-Scholes model over the service period. The estimated fair value is re-measured at each reporting date and is amortized over the remaining service period.

Income Taxes

We account for income taxes in accordance with SFAS No*. 109, Accounting for Income Taxes* (SFAS 109) and FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109,* as amended by FASB Staff Position No. 48-1 (FIN 48). This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Income tax receivables and liabilities and deferred tax assets and liabilities are recognized based on the amounts that more likely than not will be sustained upon ultimate settlement with taxing authorities.

Developing our provision for income taxes and analyzing our uncertain tax positions requires significant judgment and knowledge of federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, any valuation allowances that may be required for deferred tax assets.

We assess the realization of our deferred tax assets to determine whether an income tax valuation allowance is required. Based on such evidence that can be objectively verified, we determine whether it is more likely than not that all or a portion of the deferred tax assets will be realized. The main factors that we consider include:

- Cumulative losses in recent years;
- Income/losses expected in future years;
- The applicable statute of limitations.

Tax benefits associated with uncertain tax positions are recognized in the period in which one of the following conditions is satisfied: (1) the more likely than not recognition threshold is satisfied; (2) the position is ultimately settled through negotiation or litigation; or (3) the statute of limitations for the taxing authority to examine and challenge the position has expired. Tax benefits associated with an uncertain tax position are derecognized in the

period in which the more likely than not recognition threshold is no longer satisfied.

We concluded that the realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance.

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Net Loss per Share

Basic net loss per share is computed based on the weighted-average number of shares of our common stock outstanding during the period. Diluted net loss per share is computed based on the weighted-average number of shares of our common stock and other dilutive securities.

The following are the basic and dilutive net loss per share computations for the last three fiscal years:

	2008	2007	2006
Net loss	$ (29,086,777)	$ (25,022,802)	$ (18,948,380)
Weighted average shares outstanding used to compute basic and diluted net loss per share	82,716,455	79,772,351	74,611,196
Basic and diluted net loss per share	$ (0.35)	$ (0.31)	$ (0.25)

Outstanding options, restricted stock units and warrants to purchase shares of our common stock were excluded from the computation of diluted net loss per share because the effect would have been anti-dilutive for all periods presented below:

	2008	2007	2006
Outstanding options	8,340,530	9,028,810	8,501,503
Restricted stock units	1,650,000		
Outstanding warrants	11,599,828	1,355,000	1,930,658
Total	21,590,358	10,383,810	10,432,161

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net losses and other comprehensive income (or OCI). OCI includes certain changes in stockholders equity that are excluded from net losses. Specifically, we include in OCI changes in unrealized gains and losses on our marketable securities. Comprehensive loss for the years ended December 31, 2008, 2007 and 2006 has been reflected in the Consolidated Statements of Stockholders Equity.

The activity in OCI is as follows:

	2008	2007	2006
(Decrease) increase in unrealized gains(losses) on marketable securities	$ (1,806,768)	$ (2,756,268)	$ 3,442,125
	2,082,894		

Recognition in net loss, other than temporary impairment of marketable securities			
Reclassification adjustment for gains on marketable securities included in net income		(715,584)	
Other comprehensive income (loss)	$ 276,126	$ (3,471,852)	$ 3,442,125

Recent Accounting Pronouncements

In February 2008, the FASB issued FASB Staff Position (FSP) No. FAS 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2). FSP 157-2 delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for certain items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We are currently evaluating the impact of SFAS 157 on our consolidated financial statements for items within the scope of FSP 157-2, which will become effective beginning with our first quarter of 2009.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

In October 2008, the FASB issued FSP No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate. Adoption of FSP 157-3 did not have a material impact on our consolidated financial statements.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). FSP 142-3 amends paragraph 11(d) of SFAS 142 to require an entity to use its own assumptions about renewal or extension of an arrangement, adjusted for the entity-specific factors in paragraph 11 of SFAS 142, even when there is likely to be substantial cost or material modifications. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, with early adoption prohibited. We do not expect that the adoption of FSP 142-3 on January 1, 2009, to have a material effect on our consolidated financial condition and results of operations.

In December 2007, FASB issued SFAS No. 141R, *Business Combinations* (SFAS 141R). SFAS 141R provides companies with principles and requirements on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, liabilities assumed, and any non controlling interest in the acquiree as well as the recognition and measurement of goodwill acquired in a business combination. SFAS 141R also requires certain disclosures to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Acquisition costs associated with the business combination will generally be expensed as incurred. SFAS 141R is effective for business combinations occurring in fiscal years beginning after December 15, 2008. Early adoption of SFAS 141R is not permitted. We will be required to apply the guidance in SFAS 141R to any future business combinations effective January 1, 2009

In June 2008, the FASB issued EITF Issue No. 07-05, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock*. EITF Issue No. 07-05 clarifies the determination of whether an instrument (or an embedded feature) is indexed to an entity s own stock, which would qualify as a scope exception under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. EITF Issue No. 07-05 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption for an existing instrument is not permitted. We do not expect the adoption of EITF Issue No. 07-05 to have a material impact on our consolidated financial statements.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 2. Financial Instruments

Cash, cash equivalents and marketable securities

The following table summarizes the fair value of our cash, cash equivalents and available-for-sale securities held in our investment portfolio:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2008				
Cash	$ 243,883	$	$	$ 243,883
Cash equivalents (money market accounts)	29,799,103			29,799,103
Marketable debt securities, current (maturity within 1 year)	4,002,537		(7,748)	3,994,789
Marketable equity securities, current	186,803			186,803
Total cash, cash equivalents, and marketable securities	$ 34,232,326	$	$ (7,748)	$ 34,224,578
December 31, 2007				
Cash	$ 549,544	$	$	$ 549,544
Money market accounts	5,079,564			5,079,564
Marketable debt securities (maturity within 90 days)	4,130,404		(343)	4,130,061
Total cash equivalents	9,209,968		(343)	9,209,625
Marketable debt securities (maturity within 1 year)	26,680,824	19,137	(3,548)	26,696,413
Total marketable securities, current	26,680,824	19,137	(3,548)	26,696,413
Marketable debt securities	1,180,394	9,109		1,189,503
Marketable equity securities	2,269,697		(308,229)	1,961,468
Total marketable securities, non-current	3,450,091	9,109	(308,229)	3,150,971
Total cash, cash equivalents, and marketable securities	$ 39,890,427	$ 28,246	$ (312,120)	$ 39,606,553

At December 31, 2008, our investment in marketable debt securities were in money market accounts composed primarily of US Treasury securities and repurchase agreements that are backed by US Treasury securities.

Our investment in marketable equity securities consists of ordinary shares of ReNeuron Group plc, a publicly listed UK corporation. In July 2005, we entered into an agreement with ReNeuron. As part of the agreement, we granted ReNeuron a license that allows ReNeuron to exploit their c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. We received shares of ReNeuron common stock, as well as a cross-license to the exclusive use of ReNeuron s technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy, and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either we or ReNeuron might have had against the other in connection with any putative infringement of certain of each party s patent rights prior to the effective date of the agreement. In July and August 2005 we received approximately 8,836,000 ordinary shares of ReNeuron common stock (net of approximately 104,000 shares that were transferred to NeuroSpheres), and subsequently, as a result of

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

certain anti-dilution provisions in the agreement, we received approximately 1,261,000 more shares, net of approximately 18,000 shares that were transferred to NeuroSpheres. In February 2007, we sold 5,275,000 shares for net proceeds of approximately $3,075,000. We recognized approximately $716,000 as realized gain from this transaction. We owned approximately 4,822,000 ordinary shares of ReNeuron at December 31, 2008 and 2007.

If the fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery to the cost of the investment, and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. Other-than-temporary declines in estimated fair value of all marketable securities are charged to other income (expense), net. After considering various criteria, including the duration of the impairment and our intent to liquidate all or part of our investment within a reasonably short period of time, we determined that the impairment of our investment in ordinary shares of ReNeuron (marketable equity securities) (see Note 2, Financial Instruments, below), was other than temporary. For the year ended December 31, 2008, we recorded on our Consolidated Statements of Operations under Other Income (expense) a loss of $2,082,894, which is the difference between the investment s carrying value and its quoted market price at that date. No other than temporary impairment was recognized during the years ended December 31, 2007 and 2006.

Changes in fair value as a result of changes in market price per share or the exchange rate between the US dollar and the British pound are accounted for under other comprehensive income (loss) if deemed temporary and are not recorded as other income or loss until the shares are disposed of and a gain or loss realized or an impairment is considered other than temporary. After considering various criteria, including, the duration of the impairment and our intent to sell within a reasonably short period of time, we determined that the impairment of our investment in shares of ReNeuron (marketable equity securities) was other than temporary. For the year ended December 31, 2008, we recorded, on our Consolidated Statements of Operations under Other Income (expense) , a loss of $2,082,894, which is the difference between the investment s carrying value and its quoted market price at that date. No other than temporary impairment was recognized during the years ended December 31, 2007 and 2006.

In accordance with FASB Staff Position FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, the following table shows the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2008, aggregated by investment category and the length of time that individual securities have been in a continuous loss position:

	Less than 12 Months		12 Months of Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2008						
Marketable debt securities	$ 3,994,789	$ (7,748)	$	$	$ 3,994,789	$ (7,748)
Marketable equity securities	186,803				186,803	
Total	$ 4,181,592	$ (7,748)	$	$	$ 4,181,592	$ (7,748)

Unrealized losses in our marketable debt securities portfolio are due to four U.S. corporate debt securities primarily consisting of commercial paper. For these securities, the unrealized losses are primarily due to a change in interest rates. Because we have the ability and intent to hold these investments until a forecasted recovery of carrying value, which may be maturity or call date, we do not consider these investments to be other-than-temporarily impaired as of December 31, 2008. See Note 1, Summary of Significant Accounting Policies Cash Equivalents and Marketable Securities, for further discussion of the criteria used to determine impairment of our marketable securities.

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Notes to Consolidated Financial Statements (Continued)

Note Receivable

In December 2007, we committed to make a secured loan of up to $3.8 million to Progenitor Cell Therapy, LLC (PCT) in return for a period of exclusivity to allow for due diligence and negotiation of a possible acquisition transaction. Of this amount, $1.0 million was lent and outstanding at December 31, 2007 with the maturity date within twelve months from the effective date of the loan. In March 2008, we terminated discussions to acquire PCT. In April 2008 we were repaid the loan in accordance with its terms.

In December 2008, we made a secured loan of £200,000 (approximately $298,000) to Stem Cell Sciences Plc in connection with a potential acquisition transaction. The loan accrues interest at 8% per annum and is repayable on June 23, 2009 if the acquisition of SCS does not occur before then.

Note 3. Fair Value Measurement

Effective January 1, 2008, we adopted SFAS 157, except as it applies to the nonfinancial assets and nonfinancial liabilities subject to FSP SFAS 157-2. SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Directly or indirectly observable inputs other than in Level 1, that include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 Unobservable inputs which are supported by little or no market activity that reflects the reporting entity s own assumptions about the assumptions that market participants would use in pricing the asset or liability

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

In accordance with SFAS 157, we measure our financial assets and liabilities at fair value. Our cash equivalents and marketable securities are classified within Level 1 or Level 2. This is because our cash equivalents and marketable securities are valued primarily using quoted market prices or alternative pricing sources and models utilizing market observable inputs. We currently do not have any Level 3 financial assets or liabilities.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

The following table presents assets and liabilities measured at fair value:

	Fair Value Measurement at Reporting Date Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	As of December 31, 2008
Assets			
Cash Equivalents:			
Money market funds	$ 356,000	$	$ 356,000
U.S. Treasury obligations	29,443,103		29,443,103
Marketable Securities:			
Equity securities	186,803		186,803
Corporate bonds		2,798,580	2,798,580
Asset-backed securities		1,196,209	1,196,209
Total assets	$ 29,985,906	$ 3,994,789	$ 33,980,695
Liabilities			
Bond obligation	$	$ 1,009,166	$ 1,009,166

Note 4. Property, Plant and Equipment

Property, plant and equipment balances at December 31 are summarized below:

	2008	2007
Building and improvements	$ 3,404,969	$ 3,397,639
Machinery and equipment	6,308,603	6,002,945
Furniture and fixtures	369,068	369,068
	10,082,640	9,769,652
Less accumulated depreciation and amortization	(6,909,172)	(5,864,248)
Property, plant and equipment, net	$ 3,173,468	$ 3,905,404

Depreciation expense was approximately $1,045,000 in 2008, $1,012,000 in 2007, and $944,000 in 2006.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 5. Intangible and Other Assets

The components of our intangible assets at December 31 are summarized below:

Intangible Asset Class	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
2008			
Patents	$ 979,612	$ (515,255)	$ 464,357
License agreements	1,785,998	(1,604,817)	181,181
Total intangible assets	$ 2,765,610	$ (2,120,072)	$ 645,538
2007			
Patents	$ 979,612	$ (459,452)	$ 520,160
License agreements	1,761,623	(1,519,116)	242,507
Total intangible assets	$ 2,741,235	$ (1,978,568)	$ 762,667

Amortization expense was approximately $142,000 in 2008, $163,000 in 2007, and $101,000 in 2006.

The expected future annual amortization expense based on current balances of our intangible assets is as follows:

For the year ending December 31:	
2009	$ 119,687
2010	$ 107,499
2011	$ 69,718
2012	$ 68,545
2013	$ 66,212

Other assets at December 31 are summarized below:

	2008	2007
Prepaid royalties	$ 551,199	$ 180,250
Security deposit (building lease)	750,000	752,500
Restricted cash (letter of credit)	778,079	778,079
Total other non-current assets	$ 2,079,278	$ 1,710,829

Note 6. Accrued Expenses and Other

Accrued expenses at December 31 are summarized below:

	2008	2007
External services	$ 466,360	$ 360,340
Employee compensation	1,526,115	1,885,249
Other	268,770	216,663
Total accrued expenses and other liabilities	$ 2,261,245	$ 2,462,252

Note 7. Stock-Based Compensation

We currently grant options under three equity incentive plans and as of December 31, 2008, we had 15,227,243 shares authorized under these three plans. At our annual stockholders meeting held on June 12,

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

2007, our stockholders approved an amendment to our 2006 Equity Incentive Plan to provide for an annual increase in the number of shares of common stock available for issuance under the plan each January 1 (beginning January 1, 2008) equal to 4% of the outstanding common shares as of that date. The amendment further provided an aggregate limit of 30,000,000 shares issuable pursuant to stock based awards under the plan. Under these three plans we may grant incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units and performance-based shares to our employees, directors and consultants, at prices determined by our Board of Directors. Incentive stock options may only be granted to employees under these plans with a grant price not less than the fair market value on the date of grant.

Generally, stock options and restricted stock units granted to employees have a maximum term of ten years, and vest over a four year period from the date of grant; 25% vest at the end of one year, and 75% vest monthly over the remaining three-year service period. We may grant options with different vesting terms from time to time. Upon employee termination of service, any unexercised vested option will be forfeited three months following termination or the expiration of the option, whichever is earlier.

Our compensation expense for stock options and restricted stock units issued from our equity incentive plans for the last three fiscal years was as follows:

	2008	2007	2006
Research and development expense	$ 1,845,523	$ 1,347,239	$ 1,048,697
General and administrative expense	1,909,348	1,558,056	1,236,334
Total stock-based compensation expense and effect on net loss	$ 3,754,871	$ 2,905,295	$ 2,285,031

As of December 31, 2008, we have approximately $5,207,000 of total unrecognized compensation expense related to unvested awards granted under our various share-based plans that we expect to recognize over a weighted-average period of 2.1 years.

The fair value of options granted is estimated as of the date of grant using the Black-Scholes option pricing model and expensed on a pro-rata straight-line basis over the period in which the stock options vest. The Black-Scholes option pricing model requires certain assumptions as of the date of grant. The weighted-average assumptions used for the last three fiscal years are as follows:

	2008	2007	2006
Expected life (years)(1)	7.24	6.25	6.25
Risk-free interest rate(2)	3.23%	4.36%	4.72%
Expected volatility(3)	94.0%	95.2%	109.0%
Expected dividend yield(4)	0%	0%	0%

(1) The expected term represents the period during which our stock-based awards are expected to be outstanding. In 2008 we estimated this amount based on historical experience of similar awards, giving consideration to the contractual terms of the awards, vesting requirements, and expectation of future employee behavior, including post-vesting terminations. The expected term in 2007 and 2006 is equal to the average of the contractual life of the stock option and its vesting period as of the date of grant.

(2) The risk-free interest rate is based on U.S. Treasury debt securities with maturities close to the expected term of the option as of the date of grant.

(3) Expected volatility is based on historical volatility over the most recent historical period equal to the length of the expected term of the option as of the date of grant.

(4) We have neither declared nor paid dividends on any share of common stock and we do not expect to do so in the foreseeable future.

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

At the end of each reporting period we estimate forfeiture rates based on our historical experience within separate groups of employees and adjust the stock-based compensation expense accordingly.

A summary of our stock option activity and related information for the last three fiscal years is as follows:

	Outstanding Options			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Balance at December 31, 2005	6,608,109	$ 3.02		
Granted	2,818,684	$ 2.38		
Exercised	(369,214)	$ 1.82		
Cancelled (forfeited and expired)	(556,076)	$ 2.82		
Balance at December 31, 2006	8,501,503	$ 2.88		
Granted	2,484,100	$ 2.33		
Exercised	(175,186)	$ 1.20		
Cancelled (forfeited and expired)	(1,781,607)	$ 4.91		
Balance at December 31, 2007	9,028,810	$ 2.36	7.26	$ 826,558
Granted	353,000	$ 1.24		
Exercised	(114,700)	$ 1.11		
Cancelled (forfeited and expired)	(926,580)	$ 2.44		
Balance at December 31, 2008	8,340,530	$ 2.32	6.55	$ 692,739
Exercisable at December 31, 2008	5,726,441	$ 2.33	5.76	$ 635,969
Vested and expected to vest(2)	7,927,918	$ 2.32	6.46	$ 685,157

(1) Aggregate intrinsic value represents the value of the closing price per share of our common stock on the last trading day of the fiscal period in excess of the exercise price multiplied by the number of options outstanding or exercisable.

(2) Shares include options vested and those expected to vest net of estimated forfeitures.

The estimated weighted average fair value per share of options granted was approximately $1.00 in 2008, $1.85 in 2007, and $2.37 in 2006, based on the assumptions in the Black-Scholes model discussed above. Total intrinsic value of options exercised at time of exercise was approximately $39,000 in 2008, $397,000 in 2007, and $453,000 in 2006.

The following is a summary of changes in unvested options:

Unvested Options	**Number of Options**		**Weighted Average Grant Date Fair Value**
Unvested options at December 31, 2007	4,428,209	$	2.01
Granted	353,000		1.00
Vested	(1,792,976)		2.05
Cancelled	(374,144)		1.95
Unvested options at December 31, 2008	2,614,089	$	1.85

The estimated fair value of options vested were approximately $3,671,000 in 2008, $3,173,000 in 2007 and $2,292,000 in 2006.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

The following table presents weighted average exercise price and term information about significant option groups outstanding at December 31, 2008:

	Options Outstanding at December 31, 2008			
Range of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Term (Yrs.)**	**Weighted Average Exercise Price**	**Aggregate Intrinsic Value at December 31, 2008**
Less than $2.00	2,340,086	5.5	$ 1.17	$ 692,739
$2.00 $3.99	5,312,661	7.1	$ 2.44	
$4.00 $5.99	687,783	6.1	$ 5.27	
	8,340,530		$ 2.32	$ 692,739

	Vested Options Outstanding at December 31, 2008	
Range of Exercise Prices	**Number Outstanding**	**Weighted Average Exercise Price**
Less than $2.00	1,981,126	$ 1.16
$2.00 $3.99	3,161,619	$ 2.53
$4.00 $5.99	583,696	$ 5.26
	5,726,441	$ 2.33

Restricted Stock Units

In March 2008, we granted restricted stock units to certain employees that entitle the holders to receive shares of our common stock upon vesting. These restricted stock units vest over a three-year period from the date of grant: one-third of the award will vest on each grant date anniversary over the following three years. The fair value of restricted stock units granted are based upon the market price of the underlying common stock as if it were vested and issued on the date of grant.

A summary of our restricted stock unit activity for the year ended December 31, 2008 is as follows:

	Number of RSUs	**Weighted-Average Grant Date Fair Value**

Outstanding at January 1, 2008			
Granted	1,650,000	$	1.26
Exercised			
Cancelled			
Outstanding at December 31, 2008	1,650,000	$	1.26
Vested RSUs outstanding at December 31, 2008			

Stock Appreciation Rights

In July 2006, we granted cash-settled Stock Appreciation Rights (SARs) to certain employees under the 2006 Equity Incentive Plan. The SARs give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SAR. The exercise price of the SAR is equal to the market price of our common stock at the date of grant. The SARs vest 25% on the first anniversary of the grant date and 75% vest monthly over the remaining three-year service period. Compensation expense is based on the fair value of SARs which is calculated using the Black-Scholes option pricing model. The share-based compensation expenses and liability are re-measured at each reporting date through the date of settlement. The share-based compensation liability as re-measured at December 31, 2008 was $500,720.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

The following is a summary of the changes in non-vested SARs for the last three fiscal years:

	2008		2007		2006	
	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Outstanding at January 1,	1,478,219	$ 2.00	1,564,599	$ 2.00		
Granted					1,564,599	$ 2.00
Exercised						
Forfeited	(47,390)		(86,380)	$ 2.00		
Outstanding at December 31,	1,430,829	$ 2.00	1,478,219	$ 2.00	1,564,599	$ 2.00
Exercisable at December 31,	864,467	$ 2.00	506,754	$ 2.00		

The total compensation expense related to SARs was approximately $73,000 in 2008, $135,000 in 2007 and $294,000 in 2006. At December 31, 2008, approximately $318,000 of unrecognized compensation expense related to SARs is expected to be recognized over a weighted average period of approximately 1 year. The resulting effect on net loss and net loss per share attributable to common stockholders is not likely to be representative of the effects in future periods, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting.

Note 8. Wind-down and exit costs

In October 1999, we relocated to California from Rhode Island and established a wind-down reserve for the estimated lease payments and operating costs of the Rhode Island facilities through an expected disposal date of June 30, 2000. We did not fully sublet the Rhode Island facilities in 2000. Even though we intend to dispose of the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, we periodically re-evaluate and adjust the reserve. We consider various factors such as our lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy.

The components of our wind-down reserve at December 31 are as follows:

	2008	2007
Accrued wind-down reserve at beginning of period	$ 4,875,000	$ 5,512,000
Less actual expenses recorded against estimated reserve during the period	(1,293,000)	(1,420,000)

Additional expense recorded to revise estimated reserve at period-end	866,000	783,000
Revised reserve at period-end	4,448,000	4,875,000
Add deferred rent at period end	1,065,000	1,268,000
Total accrued wind-down expenses at period-end (current and non current)	$ 5,513,000	$ 6,143,000
Accrued wind-down expenses, current portion	$ 1,420,000	$ 1,374,000
Non current portion	4,093,000	4,769,000
Total accrued wind-down expenses	$ 5,513,000	$ 6,143,000

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 9. Commitments and Contingencies

Leases

Bonds Payable

We entered into direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling $5,000,000 to finance the construction of Rhode Island s pilot manufacturing facility. The related lease agreements are structured such that lease payments fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. Interest rates vary with the respective bonds maturities, ranging from 8.2% to 9.5%. The outstanding principal and interest owed at December 31, 2008 was approximately $1,345,000. The bonds contain certain restrictive covenants which limit, among other things, the payment of cash dividends and the sale of the related assets.

Operating leases

We entered into a fifteen-year lease agreement for a laboratory facility in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013. The lease contains escalating rent payments, which we recognize on a straight-line basis. At December 31, 2008, deferred rent expense was approximately $1,065,000 for this facility and is included as part of the wind-down accrual on the accompanying Consolidated Balance Sheet.

We entered into and amended a lease agreement for an approximately 68,000 square foot facility located at the Stanford Research Park in Palo Alto, California. The facility includes space for animals, laboratories, offices, and a GMP (Good Manufacturing Practices) suite. GMP facilities can be used to manufacture materials for clinical trials. The lease term expires March 31, 2010. Under the term of the agreement we were required to provide a letter of credit for a total of approximately $778,000, which serves as a security deposit for the duration of the lease term. The letter of credit issued by our financial institution is collateralized by a certificate of deposit for the same amount, which is reflected as restricted cash in other assets, non-current on our Consolidated Balance Sheets. The lease contains escalating rent payments, which we recognize on a straight-line basis. At December 31, 2008, deferred rent was approximately $437,000 and is reflected as deferred rent on our Consolidated Balance Sheet. At December 31, 2008, we had a space-sharing agreement covering approximately 10,451 square feet of this facility. We receive base payments plus a proportionate share of the operating expenses based on square footage over the term of the agreement.

The table below summarizes the components of rent expense for the fiscal year ended December 31, as follows:

	2008	2007	2006
Rent expense	$ 3,077,430	$ 3,077,431	$ 2,967,911
Sublease income	(809,065)	(606,398)	(616,600)
Rent expense, net	$ 2,268,365	$ 2,471,033	$ 2,351,311

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Notes to Consolidated Financial Statements (Continued)

Future minimum payments under all leases and bonds payable at December 31, 2008 are as follows:

	Bonds Payable	Capital Leases	Operating Leases	Sublease Income
2009	$ 244,572	$ 19,862	$ 3,536,843	$ 652,624
2010	242,559	6,623	1,767,304	97,508
2011	242,321		1,171,875	
2012	240,666		1,171,875	
2013	237,593		732,422	
Thereafter	136,852			
Total minimum lease payments	1,344,563	26,485	$ 8,380,319	$ 750,132
Less amounts representing interest	335,396	1,217		
Present value of bonds payable and capital lease payments	1,009,167	25,268		
Less current maturities	149,167	18,739		
Bonds payable, less current maturities	$ 860,000	$ 6,529		

Contingencies

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem s activities violate claims in four of the patents we exclusively licensed from NeuroSpheres. Neuralstem has filed a motion for dismissal or summary judgment in the alternative, citing Title 35, Section 271(e)(1) of the United States Code, which says that it is not an act of patent infringement to make, use or sell a patented invention solely for uses reasonably related to the development and submission of information to the FDA. Neuralstem argues that because it does not have any therapeutic products on the market yet, the activities complained of fall within the protection of Section 271(e)(1) that is, basically, that the suit is premature. This issue will be decided after discovery is complete. Subsequent to filing its motion to dismiss, in December 2006, Neuralstem petitioned the U.S. Patent and Trademark Office (PTO) to reexamine two of the patents in our infringement action against Neuralstem, namely U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening) and U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents). In April 2007, Neuralstem petitioned the PTO to reexamine the remaining two patents in the suit, namely U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells) and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). These requests were granted by the PTO and, in June 2007, the parties voluntarily agreed to stay the pending litigation while the PTO considers these reexamination requests. In October 2007, Neuralstem petitioned the PTO to reexamine a fifth patent, namely U.S. Patent No. 6,103,530, which claims a culture medium for proliferating mammalian neural stem cells. In April 2008, the PTO upheld the 832 and 872 patents, as amended, and issued Notices of Intent to Issue an *Ex Parte* Reexamination Certificate for both. In August 2008, the PTO upheld the 530 patent, as amended, and issued a Notice

of Intent to Issue an *Ex Parte* Reexamination Certificate. The remaining two patents are still under review by the PTO.

In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem s activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. We anticipate that the Maryland District Court will consolidate these actions in some manner prior to trial.

Note 10. Warrant Liability

In November 2008, we sold 13,793,104 units to institutional investors at a price of $1.45 per unit, for gross proceeds of $20,000,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of $2.30 per share, were offered as a registered direct offering under an effective shelf registration statement previously filed with and declared effective by the Securities and Exchange Commission. We received total proceeds, net of offering expenses and placement agency fees, of approximately $18,637,000. We recorded the fair value of the warrants to purchase 10,344,828 shares of our common stock as a liability. The fair value of the warrant liability will be revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our Consolidated Statement of Operations. We used the Black-Scholes option pricing model to estimate the fair value of these warrants. In using this model, we make certain assumptions about risk-free interest rates, dividend yields, volatility and expected term of the warrants. Risk-free interest rates are derived from the yield on U.S. Treasury securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is derived from the historical volatility of our common stock as traded on Nasdaq. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement.

The assumptions used for the Black-Scholes option pricing model are as follows:

	To Calculate Fair Value on Date of Issuance	To Calculate Fair Value at December 31, 2008
Expected life (years)	5.5	5.4
Risk-free interest rate	2.42%	1.60%
Expected volatility	83.8%	84.5%
Expected dividend yield	0%	0%

	At December 31, 2008	At November 17, 2008	Change in Fair Value of Warrant Liability at December 31, 2008
Fair value of warrant liability	$ 8,439,931	$ 7,502,690	$ 937,241

The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

Note 11. Common Stock

We have neither declared nor paid dividends on any share of common stock and do not expect to do so in the foreseeable future.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Sale of common stock

Major transactions involving our common stock for the previous three years include the following:

In November 2008, we sold 13,793,104 units to institutional investors at a price of $1.45 per unit, for gross proceeds of $20,000,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of $2.30 per share, were offered as a registered direct offering under an effective shelf registration statement previously filed with and declared effective by the Securities and Exchange Commission. We received total proceeds net of offering expenses and placement agency fees of approximately $18,637,000.

In April 2007, a warrant issued as part of our June 2004 financing was exercised to purchase an aggregate of 575,658 shares of our common stock at $1.90 per share. We issued 575,658 shares of our common stock and received proceeds of approximately $1,094,000.

In December 2006, we filed a Prospectus Supplement announcing the entry of a sales agreement with Cantor Fitzgerald & Co (Cantor) under which up to 10,000,000 shares may be sold from time to time under a shelf registration statement. In 2007 and 2008, we sold a total of 2,012,600 shares of our common stock under this agreement at an average price per share of $2.68 for gross proceeds of approximately $5,392,000. Cantor is paid compensation equal to 5.0% of the gross proceeds pursuant to the terms of the agreement.

In April 2006, we sold 11,750,820 shares of our common stock to institutional investors at a price of $3.05 per share, for gross proceeds of approximately $35,840,000. The shares were offered as a registered direct offering under an effective shelf registration statement previously filed with and declared effective by the Securities and Exchange Commission. We received total proceeds, net of offering expenses and placement agency fees, of approximately $33,422,000. No warrants were issued as part of this financing transaction.

In March 2006, a warrant issued as part of our June 2004 financing was exercised to purchase an aggregate of 526,400 shares of our common stock at $1.89 per share. We issued 526,400 shares of our common stock and received proceeds of approximately $995,000.

Stock Issued For Technology Licenses

Under license agreements with NeuroSpheres, Ltd., we obtained an exclusive patent license covering all uses of certain neural stem cell technology. We made up-front payments to NeuroSpheres of 65,000 shares of our common stock and $50,000, and will make additional cash payments as stated milestones are achieved. Effective in 2004, we began making annual $50,000 payments, creditable against certain royalties.

Pursuant to the terms of a license agreement with the California Institute of Technology (Cal Tech) and our acquisition of its wholly owned subsidiary, StemCells California, we issued 14,513 shares of common stock to Cal Tech. We issued an additional 12,800 shares of common stock to Cal Tech with a market value of approximately $40,000 in May 2000, upon execution of an amendment adding four families of patent applications to the license agreement. In August 2002, we acquired an additional license from Cal Tech for a different technology, pursuant to which we issued 27,535 shares of our common stock with a market value of approximately $35,000. We also issued (with a market value of approximately $10,000 each year), 6,924 shares in 2008, 3,865 shares in 2007, 3,848 shares in

2006, and 9,535 shares (market value of approximately $15,000) in 2004 of our common stock to Cal Tech for the issuance and annual license fees of two patents covered under this additional license.

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Common Stock Reserved

We reserved the following shares of common stock for the exercise of options, warrants and other contingent issuances of common stock, as of December 31, 2008:

Shares reserved for share based compensations	16,542,533
Shares reserved for warrants related to financing transactions	11,599,828
Shares reserved for license agreements	85,363
Shares reserved for possible future issuances under an effective shelf registration	62,678,858
Total	90,906,582

Note 12. Grant Revenue

In October 2008, we were awarded a $305,000 grant from the National Institute of Diabetes and Digestive and Kidney Diseases to research and develop a potential cell-based therapeutic for liver disease arising from infection by the hepatitis C virus. The award is a Phase I grant under the Small Business Innovation Research (SBIR) Program of the National Institutes of Health. Should the objectives of the research funded by this grant be met, we anticipate applying for Phase II and additional funding under the SBIR Program. We recognized approximately $26,000 as grant revenue in 2008 related to this grant.

In September 2004, we were awarded a Small Business Technology Transfer (STTR) grant for approximately $464,000 for studies in Alzheimer s disease conducted over an 18 month period. The grant supported joint work with Dr. George A. Carlson of the McLaughlin Research Institute (MRI) in Great Falls, Montana. We received and recognized approximately $26,000 in 2006, $186,000 in 2005, and $38,000 in 2004 as grant revenue, the remainder was reimbursed to MRI.

Note 13. 401(k) Plan

Our 401(k) Plan covers substantially all of our employees. Participants in the plan are permitted to contribute a fixed percentage of their total annual cash compensation to the plan (subject to the maximum employee contribution defined by law). We match 50% of employee contributions, up to a maximum of 6% of each employee s eligible compensation in the form of shares of common stock. We recorded an expense of $181,000 in 2008, $179,000 in 2007, and $157,000 in 2006 for our contributions under our 401(k) Plan.

Note 14. Income Taxes

In July 2006, the FASB issued FIN 48 which clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. We adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not impact our consolidated financial condition, results of operations or cash flows. At the adoption date of January 1, 2007 and as of December 31, 2008 and 2007, we have not recorded any unrecognized tax benefits. Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets and liabilities at December 31 are as follows:

	2008	2007
Deferred tax assets:		
Capitalized research and development costs	$ 38,670,000	$ 31,779,000
Net operating losses	42,247,000	42,716,000
Research and development credits	6,671,000	6,103,000
Accrued wind down cost	1,780,000	1,950,000
Stock-based compensation	465,000	245,000
Impaired asset	833,000	
Other	458,000	329,000
	91,124,000	83,122,000
Valuation allowance	(91,124,000)	(83,122,000)
Net deferred tax assets	$	$

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased by approximately $8,002,000 in 2008, $8,632,000 in 2007, and $7,105,000 in 2006.

As of December 31, 2008, we had the following:

Net operating loss carry forwards for federal income tax purposes of approximately $119,500,000 which expire in the years 2009 through 2028.

Federal research and development tax credits of approximately $4,911,000 which expire in the years 2009 through 2028.

Net operating loss carry forwards for state income tax purposes of approximately $26,964,000 which expire in the years 2009 through 2029.

State research and development tax credits of approximately $2,666,000 ($1,760,000 net of federal tax effect) which do not expire.

The effective tax rate as a percentage of income before income taxes differs from the statutory federal income tax rate (when applied to income before income taxes) for the years ended December 31 as follows:

	2008	2007	2006

Statutory federal income tax (benefit) rate	(34)%	(34)%	(34)%
State income tax (benefit) rate	(6)	(6)	(6)
Increase resulting from:			
Expenses not deductible for taxes	5.8	4.9	5.3
Increase in valuation allowance	34.2	35.1	34.7
Effective tax (benefit) rate	0%	0%	0%

Our policy is to recognize interest and penalties related to income tax matters in income tax expense. Because we have no tax liabilities, no tax-related interest and penalties have been expensed in our consolidated statements of operations during 2008 or accrued as a liability in our consolidated balance sheets at December 31, 2008. We do not anticipate any significant changes to total unrecognized tax benefits as a result of settlement of audits or the expiration of statute of limitations within the next twelve months.

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

We file U.S. federal income tax returns, as well as tax returns with the State of California and the State of Rhode Island. Due to the carry forward of unutilized net operating losses and research and development credits, our federal tax returns from 1994 forward remain subject to examination by the Internal Revenue Service, and our State of California tax returns from 2000 forward and our State of Rhode Island tax returns from 2003 forward remain subject to examination by the respective state tax authorities.

Note 15. Subsequent Events

At December 31, 2008, we owned 4,821,924 shares of ReNeuron (marketable equity securities) trading on the Alternative Investment Market (a sub-market of the London Stock Exchange) with a carrying and fair market value of $187,000. In the first quarter of 2009, we sold in aggregate, approximately 2,900,000 shares of ReNeuron and received proceeds of approximately $512,000 for a realized gain of approximately $400,000.

In February 2009, a warrant issued as part of a June 2004 financing arrangement, was exercised to purchase an aggregate of 164,474 shares of our common stock at $1.90 per share. We issued 164,474 shares of our common stock and received proceeds of approximately $312,500.

In the first quarter of 2009, we sold in aggregate, 3,325,000 shares of our common stock pursuant to the sales agreement we entered into with Cantor, at an average price per share of $2.10 for gross proceeds of approximately $6,999,000. Cantor is paid compensation equal to 5.0% of the gross proceeds pursuant to the terms of the agreement.

In March 2009, we entered into an asset purchase agreement with Stem Cell Sciences Plc (SCS) to acquire substantially all of the operating assets and liabilities of SCS (the Acquisition). The Acquisition is subject to customary closing conditions, including the approval of the stockholders of SCS, and is expected to close shortly after the SCS extraordinary general meeting scheduled for March 27, 2009. As consideration for the operating assets and liabilities to be acquired, we will issue to SCS, except as provided below, 2,650,000 shares of our common stock, plus waive certain commitments of SCS to repay approximately $715,000 in cash made available by us to SCS for working capital purposes. The actual number of shares delivered to SCS at the closing will depend on the SCS operating subsidiaries having a specified minimum amount of working capital. In connection with the Acquisition, we also entered into a loan facility agreement with SCS pursuant to which we agreed to lend up to $415,000 to SCS for working capital prior to the closing of the Acquisition. Upon closing of the Acquisition, we will waive SCS obligations to repay any amounts borrowed by SCS under this loan facility agreement as well as £200,000 (approximately $298,000) previously borrowed by SCS from us in December 2008. The principal amounts owed on both of these loans accrue interest at 8% per annum and such principal amounts and accrued interest will become due and payable on June 23, 2009 if the Acquisition does not occur beforehand.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

QUARTERLY FINANCIAL DATA (unaudited)

	2008 Quarter Ended			
	December 31	September 30	June 30	March 31
	(In thousands, except per share amounts)			
Total revenue	$ 172	$ 12	$ 30	$ 17
Operating expenses(1)	7,270	5,857	6,929	6,914
Other income (expense), net(2)	(2,985)	101	183	352
Net loss	(10,082)	(5,744)	(6,716)	(6,545)
Basic and diluted net loss per share	$ (0.11)	$ (0.07)	$ (0.08)	$ (0.09)

	2007 Quarter Ended			
	December 31	September 30	June 30	March 31
	(In thousands, except per share amounts)			
Total revenue	$ 30	$ 13	$ 8	$ 6
Operating expenses(1)	8,353	7,749	6,041	6,505
Other income, net	497	582	609	1,880
Net loss	(7,826)	(7,154)	(5,424)	(4,619)
Basic and diluted net loss per share	$ (0.10)	$ (0.09)	$ (0.07)	$ (0.06)

(1) Includes adjustment of wind-down accrual see Note 8.

(2) Other expense, net, for the quarter ended December 31, 2008, includes a loss of $937,241 relating to the change in fair value of our warrant liability see Note 10, and a $2,082,894 other than temporary impairment of marketable securities see Note 2.

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Item 9. ***CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE***

None.

Item 9A. ***CONTROLS AND PROCEDURES***

Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of its chief executive officer and chief financial officer, evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this annual report. Based on this evaluation, the Company s principal executive officer and principal financial officer concluded that these disclosure controls and procedures are effective to ensure that the information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the requisite time periods, and to provide reasonable assurance that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company s management, including its chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There have been no changes in the Company s internal control over financial reporting during the quarter ended December 31, 2008, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Management s Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s management, including its principal executive officer and principal financial officer, assessed the effectiveness of its internal control over financial reporting based on the framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The evaluation of the design and operating effectiveness of internal control over financial reporting include among others those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements.

During the fiscal year 2008, the Company periodically tested the design and operating effectiveness of its internal control over financial reporting. Among other matters, the Company sought in its evaluation to determine whether there were any significant deficiencies or material weakness in its internal control over financial reporting, or whether

it had identified any acts of fraud involving management or other employees.

Based on the above evaluation, the Company s chief executive officer and chief financial officer have concluded that as of December 31, 2008, the Company s internal control over financial reporting were effective. Nonetheless, it is important to acknowledge that due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company s internal control over financial reporting as of December 31, 2008 has been audited by Grant Thornton LLP, an independent registered public accounting firm, as stated in their report below.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Stockholders
StemCells, Inc.

We have audited StemCells, Inc. (a Delaware corporation) and subsidiary s (collectively, the Company) internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, StemCells, Inc. and subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008 based on criteria established in *Internal Control Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of StemCells, Inc. and subsidiary as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2008 and our report dated March 11, 2009 expressed an unqualified opinion thereon.

/s/ GRANT THORNTON LLP

San Francisco, California
March 11, 2009

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Item 9B. ***Other Information***

None

PART III

Item 10. ***DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT***

Executive Officers

Below are the name, age and principal occupations for the last five years of each executive officer of StemCells, Inc., as of February 28, 2009. All such persons have been elected to serve until their successors are elected and qualified or until their earlier resignation or removal.

Martin M. McGlynn, President and Chief Executive Officer	62	Martin M. McGlynn joined the company on January 2001, when he was appointed President and Chief Executive Officer of the company and of its wholly-owned subsidiary, StemCells California, Inc. He was elected to the Board of Directors in February 2001.
Ann Tsukamoto, Ph.D. Executive Vice President, Research and Development	56	Ann Tsukamoto, Ph.D., joined the company in November 1997 as Senior Director of Scientific Operations; was appointed Vice President, Scientific Operations in June 1998; Vice President, Research and Development in February 2002; and Chief Operating Officer, with responsibility for the company s research and development efforts, in November 2006. In October 2008, Dr. Tsukamoto was appointed to the newly created position of Executive Vice President, Research and Development with responsibility for the Company s scientific and clinical development programs.
Rodney K.B. Young, Chief Financial Officer and Vice President, Finance and Administration	46	Rodney K.B. Young joined the company in September 2005 as Chief Financial Officer and Vice President, Finance. In November 2006 he became CFO and Vice President, Finance and Administration. He is responsible for functions that include Finance, Information Technology and Investor Relations. From 2003 to 2005, Mr. Young was Chief Financial Officer and a director of Extropy Pharmaceuticals, Inc., a private biopharmaceutical company focused on developing drugs for pediatric indications.
Stewart Craig, Ph.D. Senior Vice President, Development and Operations	47	Stewart Craig, Ph.D., joined the company in September 2008 with responsibilities for Development, Manufacturing, Regulatory, Quality Systems and Facilities. From 2005 to 2008, Dr. Craig was Chief Technology Officer and Vice President of Progenitor Cell Therapy, a contract services provider for research, development, manufacture and commercialization of cell-based therapies, prior to which he has held executive positions at Xcyte Therapies, Osiris Therapeutics and SyStemix.

Kenneth Stratton, JD General Counsel	Kenneth Stratton, JD, joined the company in February 2007 as General Counsel, with responsibility for corporate compliance and legal affairs. In March 2008, he assumed responsibilities for the Human Resources function. Prior to StemCells, Mr. Stratton served as Deputy General Counsel for Threshold Pharmaceuticals and as Senior Legal Counsel for Medtronic s Vascular business unit.

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Directors

Below are the name, age and principal occupations for the last five years of each Director of StemCells, Inc., as of February 29, 2008. Directors are elected to staggered three year terms.

Eric H. Bjerkholt	49	Eric H. Bjerkholt was elected to the Board of Directors in March 2004. Mr. Bjerkholt joined Sunesis Pharmaceuticals, Inc., in 2004 as Senior Vice President and Chief Financial Officer. Since February 2007, he has served as Senior Vice President, Corporate Development and Finance, and Chief Financial Officer. From 2002 to 2004, Mr. Bjerkholt was Senior Vice President and Chief Financial Officer at IntraBiotics Pharmaceuticals, Inc.
Ricardo B. Levy, Ph.D.	64	Ricardo B. Levy, Ph.D. was elected to the Board of Directors in September 2001. He currently serves on several boards of directors.
Martin M. McGlynn	62	Martin M. McGlynn was elected to the Board of Directors in February 2001. He is President and Chief Executive Officer of the Company, a position he has held since January 2001.
Roger Perlmutter, M.D., Ph.D.	56	Roger M. Perlmutter, M.D., Ph.D., was elected to the Board of Directors in December 2000. He is Executive Vice President, Research and Development, of Amgen, Inc., a position he has held since January 2001.
John J. Schwartz, Ph.D.	74	John J. Schwartz, Ph.D., was elected to the Board of Directors in December 1998 and was elected Chairman of the Board at the same time. He is currently President of Quantum Strategies Management Company.
Irving Weissman, M.D.	69	Irving L. Weissman, M.D., was elected to the Board of Directors in September 1997. He is the Virginia and Daniel K. Ludwig Professor of Cancer Research, Professor of Pathology and Professor of Developmental Biology at Stanford.

Certain other information required by this Item regarding our officers, Directors, and corporate governance is incorporated herein by reference to the information appearing under the headings Information About Our Directors and Information About Ownership of Our Common Stock in our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days of December 31, 2008 (the 2009 Proxy Statement).

Item 11. *EXECUTIVE COMPENSATION*

The information required by this Item is incorporated by reference from Item 5 of this Annual Report on Form 10-K and our Proxy Statement for the 2009 Annual Meeting of Stockholders.

Item 12. *SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS*

The information required by this Item is incorporated by reference from Item 5 of this Annual Report on Form 10-K and from our Proxy Statement for the 2009 Annual Meeting of Stockholders.

Item 13. ***CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS***

The information required by this Item is incorporated by reference from our Proxy Statement for the 2009 Annual Meeting of Stockholders.

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Item 14. ***PRINCIPAL ACCOUNTING FEES AND SERVICES***

The information required by this Item is incorporated by reference from our Proxy Statement for the 2009 Annual Meeting of Stockholders.

PART IV

Item 15. ***EXHIBITS AND FINANCIAL STATEMENT SCHEDULES***

(a) The following documents are included as part of this Annual Report on Form 10-K.

(1) Financial Statements:

The financial statements filed as part of this Report are listed and indexed under Item 8 above.

(2) Financial Statement Schedules:

Schedules are not included herein because they are not applicable or the required information appears in the Financial Statements or Notes thereto.

(3) Exhibits.

The documents set forth below are filed herewith or incorporated by reference to the location indicated.

Exhibit No.	Title or Description
3.1-	Restated Certificate of Incorporation of the Registrant
3.2--	Amended and Restated By-Laws of the Registrant
4.1^^	Specimen common stock Certificate
4.2{*}	Warrant to Purchase common stock Riverview Group, LLC
4.3XXXX	Warrant to Purchase common stock Cantor Fitzgerald & Co.
4.4&2	Warrant to Purchase common stock Riverview Group, LLC
4.5&4	Form of Warrant Certificate issued to a certain purchasers of the Registrant s common stock in November 2008
10.1	Form of at-will Employment Agreement between the Registrant and most of its employees
10.2*	Form of Agreement for Consulting Services between the Registrant and members of its Scientific Advisory Board
10.3	Form of Nondisclosure Agreement between the Registrant and its Contractors
10.4*	1992 Equity Incentive Plan
10.5*	1992 Stock Option Plan for Non-Employee Directors
10.6+	Research Agreement, dated as of March 16, 1994, between NeuroSpheres, Ltd. and Registrant
10.7+	Lease Agreement between the Registrant and Rhode Island Industrial Facilities Corporation, dated as of August 1, 1992
10.8+	First Amendment to Lease Agreement between Registrant and The Rhode Island Industrial Facilities Corporation dated as of September 15, 1994
10.9#	Lease Agreement, dated as of November 21, 1997, by and between Hub RI Properties Trust, as Landlord, and CytoTherapeutics, Inc., as Tenant
10.10!	

	Consulting Agreement, dated as of September 25, 1997, between Dr. Irving Weissman and the Registrant
10.11!!!	StemCells, Inc. 1996 Stock Option Plan
10.12!!!	1997 StemCells Research Stock Option Plan (the 1997 Plan)
10.13!!!	Form of Performance-Based Incentive Option Agreement issued under the 1997 Plan
10.14XX	License Agreement, dated as of October 30, 2000, between the Registrant and NeuroSpheres Ltd.
10.15XX	Letter Agreement, dated January 2, 2001, between the Registrant and Martin McGlynn

Exhibit No.	Title or Description
10.16XX	Lease, dated February 1, 2001, between the Board of Trustees of Stanford University and the Registrant
10.17$$	2001 Equity Incentive Plan
10.18^^^	Form of Securities Purchase Agreement, dated as of June 16, 2004, between the Registrant and certain Purchasers parties thereto
10.19^^^	Form of Warrant
10.20^^^^	Amended and Restated 2004 Equity Incentive Plan of the Registrant
10.21§	License Agreement, dated as of July 1, 2005, between the Registrant and ReNeuron Limited
10.22§§	Letter Agreement, effective as of September 6, 2005, between the Registrant and Rodney K.B. Young
10.23XX	Side Letter, dated March 17, 2001, between the Company and Oleh S. Hnatiuk regarding NeuroSpheres License Agreement, dated October 30, 2000
10.24@	License Agreement, dated April 1, 1997, by and among Registrant, NeuroSpheres Ltd. and NeuroSpheres Holdings Ltd.
10.25§§§	Indemnification Agreement, dated July 9, 2008, by and between registrant and NeuroSpheres Holdings, LTD.
10.26	Facility Agreement, dated December 23, 2008, by and among registrant and Stem Cell Sciences Plc
10.27	Second Facility Agreement, dated March 1, 2009, by and among registrant, Stem Cell Sciences Plc and Stem Cell Sciences Holdings Limited
10.28	Asset Purchase Agreement, dated March 1, 2009, by and between registrant and Stem Cell Sciences Plc
14.1	Code of Ethics
21X	Subsidiaries of the Registrant
23.1	Consent of Grant Thornton, LLP , Independent Registered Public Accounting Firm
31.1	Certification Pursuant to Securities Exchange Act Rule 13(a)-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Martin McGlynn, Chief Executive Officer)
31.2	Certification Pursuant to Securities Exchange Act Rule 13(a)-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rodney K.B. Young, Chief Financial Officer)
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Martin McGlynn, Chief Executive Officer)
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rodney K.B. Young, Chief Financial Officer)

! Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1997 and filed on November 14, 1997.

!! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

!!! Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Registration Statement on Form S-8, File No. 333-37313.

$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s annual report on Form 10-K for the fiscal year ended December 31, 1998 and filed on March 31,

1999.

$$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s definitive proxy statement filed May 1, 2001.

% Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on December 10, 2003.

%% Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003

&1 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on April 15, 2003.

&2 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on May 13, 2003.

&3 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on May 15, 2003.

&4 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on November 12, 2008.

* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, Registration Statement on Form S-1, File No. 33-45739.

** Confidential treatment requested as to certain portions. The term confidential treatment and the mark ** as used throughout the indicated Exhibits mean that material has been omitted and separately filed with the Commission.

ˆ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on December 29, 2006.

ˆˆ Previously filed with the Commission as an Exhibit to, and incorporated by reference to, the Registrant s Registration Statement on Form S-3, File No. 333-151891.

ˆˆˆ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K filed on June 17, 2004.

ˆˆˆˆ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrants Registration Statement on Form S-8, File No. 333-118263.

{*} Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K filed on December 7, 2001.

+ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Registration Statement on Form S-1, File No. 33-85494.

++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Registration Statement on Form S-1, File No. 33-91228.

- Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and filed on March 15, 2007.

-- Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on May 7, 2007.

§ Previously filed with the Commission as an Exhibit to and incorporated herein by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

§§ Previously filed with the Commission as an Exhibit to and incorporated herein by reference to, the Registrant s current report on Form 8-K filed on September 7, 2005.

§§§ Previously filed with the Commission as an Exhibit to and incorporated herein by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2008

X Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Registration Statement on Form S-1, File No. 333-45496.

XX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 and filed on April 2, 2001.

XXX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Registration Statement filed on Form S-1 as amended to Form S-3, File No. 333-61726.

XXXX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Registration Statement filed on Form S-3, File No. 333-75806.

@ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Annual Report on Form 10-K/A for the fiscal year ended December 31, 2006 and filed on April 1, 1997.

Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s annual report on Form 10-K for the fiscal year ended December 31, 1997 and filed on March 30, 1998.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

STEMCELLS, INC.

By: /s/ MARTIN MCGLYNN
Martin McGlynn
PRESIDENT AND CHIEF
EXECUTIVE OFFICER

Dated: March 13, 2009

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ Martin McGlynn Martin McGlynn	President and Chief Executive Officer and Director (principal executive officer)	March 13, 2009
/s/ Rodney K.B. Young Rodney K.B. Young	Chief Financial Officer (principal financial officer)	March 13, 2009
/s/ George Koshy George Koshy	Chief Accounting Officer (principal accounting officer)	March 13, 2009
/s/ Eric Bjerkholt Eric Bjerkholt	Director	March 13, 2009
/s/ Ricardo B. Levy, Ph.D Ricardo B. Levy, Ph.D.	Director	March 13, 2009
/s/ Roger M. Perlmutter, M.D. Roger M. Perlmutter, M.D.	Director	March 13, 2009
/s/ John J. Schwartz, Ph. D. John J. Schwartz, Ph.D.	Director, Chairman of the Board	March 13, 2009

/s/ Irving L. Weissman, M.D.	Director	March 13, 2009
Irving L. Weissman, M.D.		

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Exhibit Index

Exhibit No.	Title or Description
3.1-	Restated Certificate of Incorporation of the Registrant
3.2--	Amended and Restated By-Laws of the Registrant
4.1^^	Specimen common stock Certificate
4.2{*}	Warrant to Purchase common stock Riverview Group, LLC
4.3XXXX	Warrant to Purchase common stock Cantor Fitzgerald & Co.
4.4&2	Warrant to Purchase common stock Riverview Group, LLC
4.5&4	Form of Warrant Certificate issued to a certain purchasers of the Registrant s common stock in November 2008
10.1	Form of at-will Employment Agreement between the Registrant and most of its employees
10.2*	Form of Agreement for Consulting Services between the Registrant and members of its Scientific Advisory Board
10.3	Form of Nondisclosure Agreement between the Registrant and its Contractors
10.4*	1992 Equity Incentive Plan
10.5*	1992 Stock Option Plan for Non-Employee Directors
10.6+	Research Agreement, dated as of March 16, 1994, between NeuroSpheres, Ltd. and Registrant
10.7+	Lease Agreement between the Registrant and Rhode Island Industrial Facilities Corporation, dated as of August 1, 1992
10.8+	First Amendment to Lease Agreement between Registrant and The Rhode Island Industrial Facilities Corporation dated as of September 15, 1994
10.9#	Lease Agreement, dated as of November 21, 1997, by and between Hub RI Properties Trust, as Landlord, and CytoTherapeutics, Inc., as Tenant
10.10!	Consulting Agreement, dated as of September 25, 1997, between Dr. Irving Weissman and the Registrant
10.11!!!	StemCells, Inc. 1996 Stock Option Plan
10.12!!!	1997 StemCells Research Stock Option Plan (the 1997 Plan)
10.13!!!	Form of Performance-Based Incentive Option Agreement issued under the 1997 Plan
10.14XX	License Agreement, dated as of October 30, 2000, between the Registrant and NeuroSpheres Ltd.
10.15XX	Letter Agreement, dated January 2, 2001, between the Registrant and Martin McGlynn
10.16XX	Lease, dated February 1, 2001, between the Board of Trustees of Stanford University and the Registrant
10.17$$	2001 Equity Incentive Plan
10.18^^^	Form of Securities Purchase Agreement, dated as of June 16, 2004, between the Registrant and certain Purchasers parties thereto
10.19^^^	Form of Warrant
10.20^^^^	Amended and Restated 2004 Equity Incentive Plan of the Registrant
10.21§	License Agreement, dated as of July 1, 2005, between the Registrant and ReNeuron Limited
10.22§§	Letter Agreement, effective as of September 6, 2005, between the Registrant and Rodney K.B. Young
10.23XX	Side Letter, dated March 17, 2001, between the Company and Oleh S. Hnatiuk regarding NeuroSpheres License Agreement, dated October 30, 2000
10.24@	License Agreement, dated April 1, 1997, by and among Registrant, NeuroSpheres Ltd. and NeuroSpheres Holdings Ltd.
10.25§§§	Indemnification Agreement, dated July 9, 2008, by and between registrant and NeuroSpheres Holdings, LTD.

10.26	Facility Agreement, dated December 23, 2008, by and among registrant and Stem Cell Sciences Plc

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Exhibit No.	Title or Description
10.27	Second Facility Agreement, dated March 1, 2009, by and among registrant, Stem Cell Sciences Plc and Stem Cell Sciences Holdings Limited
10.28	Asset Purchase Agreement, dated March 1, 2009, by and between registrant and Stem Cell Sciences Plc
14.1	Code of Ethics
21X	Subsidiaries of the Registrant
23.1	Consent of Grant Thornton, LLP , Independent Registered Public Accounting Firm
31.1	Certification Pursuant to Securities Exchange Act Rule 13(a)-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Martin McGlynn, Chief Executive Officer)
31.2	Certification Pursuant to Securities Exchange Act Rule 13(a)-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rodney K.B. Young, Chief Financial Officer)
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Martin McGlynn, Chief Executive Officer)
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rodney K.B. Young, Chief Financial Officer)

! Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1997 and filed on November 14, 1997.

!! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

!!! Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant s Registration Statement on Form S-8, File No. 333-37313.

$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s annual report on Form 10-K for the fiscal year ended December 31, 1998 and filed on March 31, 1999.

$$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s definitive proxy statement filed May 1, 2001.

% Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on December 10, 2003.

%% Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003

&1 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on April 15, 2003.

&2 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on May 13, 2003.

&3 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on May 15, 2003.

&4 Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on November 12, 2008.

* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, Registration Statement on Form S-1, File No. 33-45739.

** Confidential treatment requested as to certain portions. The term confidential treatment and the mark ** as used throughout the indicated Exhibits mean that material has been omitted and separately filed with the Commission.

ˆ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant s current report on Form 8-K on December 29, 2006.

ˆˆ Previously filed with the Commission as an Exhibit to, and incorporated by reference to, the Registrant s Registration Statement on Form S-3, File No. 333-151891.

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