SPACEHAB INC \WA\
Form 10-Q
February 12, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2008

OR

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

For the transition period from to

Commission File Number: 0-27206

SPACEHAB, Incorporated

(Exact name of registrant as specified in this charter)

Washington	**91-1273737**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

907 Gemini Street

Houston, Texas 77058-2762

(Address of principal executive offices and zip code)

(713) 558-5000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

Large accelerated filer o Accelerated filer o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes o No x

As of February 10, 2009 there were 16,392,718 shares of the registrant s common stock outstanding.

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SPACEHAB, INCORPORATED AND SUBSIDIARIES

December 31, 2008 QUARTERLY REPORT ON FORM 10-Q

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DEFINITIONS

As used in this Form 10-Q, the abbreviations and acronyms contained herein have the meanings set forth below. Additionally, the terms SPACEHAB , the Company , we , us and our refer to SPACEHAB, Incorporated and its subsidiaries, unless the context clearly indicates otherwise.

1994 Plan	1994 Stock Incentive Plan
2008 Plan	2008 Stock Incentive Plan
Astrium	Astrium GmbH
Astrotech	Astrotech Space Operations
CMC	Cargo Mission Contract
Common stock	SPACEHAB common stock
EPS	Earnings Per Share
ICC	Integrated Cargo Carrier
ISS	International Space Station
Lockheed Martin	Lockheed Martin Corporation
NASA	National Aeronautics and Space Administration
PI&C	Program Integration and Control
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SFS	SPACEHAB Flight Services
SOTS	SPACEHAB Orbital Transportation Services
VCC	Vertical Cargo Carrier

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PART I: FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SPACEHAB, INCORPORATED AND SUBSIDIARIES

Unaudited Condensed Consolidated Balance Sheets

(In thousands, except share data)

	December 31 2008	June 30, 2008
Assets		
Current assets		
Cash and cash equivalents	$ 214	$ 2,640
Accounts receivable, net	4,842	3,872
Inventory	466	482
Short term note receivable, net	175	175
Prepaid expenses and other current assets	476	464
Total current assets	6,173	7,633
Property and equipment		
Flight assets	49,210	49,210
Capital improvements in progress	263	76
Payload processing facilities	42,600	42,600
Furniture, fixtures, equipment and leasehold improvements	18,440	18,244
	110,513	110,130
Less accumulated depreciation and amortization	(70,213)	(69,131)
Property and equipment, net	40,300	40,999
Restricted cash	7,079	8,386
Deferred financing costs, net	114	264
Long term note receivable, net	705	717
Other assets, net	205	212
Total assets	$ 54,576	$ 58,211
Liabilities and Stockholders Equity		
Current liabilities		
Term note payable - current	$ 267	$ 267
Accounts payable	1,960	1,845
Accounts payable- Astrium	297	754
Income tax payable	463	463
Accrued interest	83	83
Accrued expenses	687	2,124
Deferred gains on sale of buildings, current portion	86	86
Deferred revenue, current portion	2,626	1,007
Total current liabilities	6,469	6,629
Accrued contract costs and other	57	40
Advances on construction contract	3,989	4,863
Deferred gains on sale of buildings, non-current	86	129
Deferred revenue, non-current	1,162	1,227
Term note payable - non current (net of discount)	3,433	3,526

Senior convertible subordinated notes payable 5.5%		5,111		6,861
Total liabilities		20,307		23,275
Commitments and contingencies				
Stockholders equity				
Common stock, no par value, 75,000,000 shares authorized 16,392,718 and 14,942,718 shares outstanding, respectively		183,306		183,306
Treasury stock, 11,660 shares at cost		(117)		(117)
Additional paid-in capital		1,523		691
Accumulated deficit		(150,443)		(148,944)
Total stockholders equity		34,269		34,936
Total liabilities and stockholders equity	$	54,576	$	58,211

See accompanying notes to unaudited condensed consolidated financial statements.

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SPACEHAB, INCORPORATED AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(In thousands, except share data)

	Three Months Ended December 31, 2008	Three Months Ended December 31, 2007	Six Months Ended December 31, 2008	Six Months Ended December 31, 2007
Revenue	$ 3,786	$ 4,310	$ 9,760	$ 12,906
Costs of revenue	3,250	4,455	6,768	10,892
Gross profit	536	(145)	2,992	2,014
Operating expenses:				
Selling, general and administrative	2,150	2,199	3,849	4,013
Research and development	510	444	1,083	762
Total operating expenses	2,660	2,643	4,932	4,775
Loss from operations	(2,124)	(2,788)	(1,940)	(2,761)
Interest expense	(187)	(46)	(410)	(1,113)
Debt conversion expense		(30,191)		(30,191)
Gain on notes repurchased	665		665	
Interest and other income, net	92	182	186	366
Loss before income taxes	(1,554)	(32,843)	(1,499)	(33,699)
Income tax (expense) benefit				
Net loss	$ (1,554)	$ (32,843)	$ (1,499)	$ (33,699)
Loss per share:				
Deemed dividend related to induced conversion of preferred shares	$	$ (3,344)	$	$ (3,344)
Net loss applicable to common shares	$ (1,554)	$ (36,187)	$ (1,499)	$ (37,043)
Loss per common share:				
Loss per share basic and diluted	$ (0.09)	$ (4.36)	$ (0.09)	$ (7.72)
Shares used in computing net loss per share basic and diluted	16,392,718	8,293,710	16,250,871	4,798,215

See accompanying notes to unaudited condensed consolidated financial statements.

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SPACEHAB, INCORPORATED AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)

	Six Months Ended December 31, 2008		2007	
Cash flows from operating activities				
Net loss	$	(1,499)	$	(33,699)
Adjustments to reconcile net loss to net cash used in operating activities:				
Non-cash debt conversion expense				30,191
Gain on note repurchase		(665)		
Stock-based compensation		180		145
Depreciation and amortization		1,129		1,561
Amortization of deferred financing cost		111		171
Recognition of deferred gain		(43)		(111)
Inventory write down		6		
Loss on asset sales		(11)		
Changes in assets and liabilities:				
Decrease (increase) in restricted cash		1,307		(3,907)
(Increase) decrease in accounts receivable		(958)		3,377
Decrease (increase) in prepaid expenses and other current assets		67		(523)
Decrease in inventory		10		
Decrease in other assets		3		343
Increase (decrease) in deferred revenue		1,554		(629)
Increase (decrease) in accounts payable, accounts payable-Astrium, accrued interest, and accrued expenses		(1,128)		1,982
Decrease in customer deposits				(3,106)
Decrease in accrued subcontracting services and other				(3,612)
Increase (decrease) in advance on construction contract		(1,116)		1,467
Increase (decrease) in long-term accrued contract costs and other liabilities		17		(86)
Net cash used in operating activities		(1,036)		(6,436)
Cash flows from investing activities				
Purchases of property, equipment and leasehold improvements, net of reimbursements		(172)		(80)
Net cash used in investing activities		(172)		(80)
Cash flows from financing activities				
Payment of term note payable		(133)		
Repurchase of notes		(1,085)		(2,867)
Net cash used in financing activities		(1,218)		(2,867)
Net change in cash and cash equivalents		(2,426)		(9,383)
Cash and cash equivalents at beginning of period		2,640		9,724
Cash and cash equivalents at end of period	$	214	$	341
Non-cash financing activities:				
Issuance of common stock for bonds	$		$	83,031
Issuance of common stock for preferred stock	$		$	11,892
Deemed dividend related to induced conversion of preferred shares	$		$	3,344
Cash paid for interest	$	335	$	316
Cash paid for income taxes	$		$	

See accompanying notes to unaudited condensed consolidated financial statements.

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SPACEHAB, INCORPORATED AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

1. Description of the Company and Operating Environment

SPACEHAB is a provider of governmental and commercial spacecraft pre-launch processing facilities and services, a provider of manned and unmanned payload processing services, and an entrepreneurial force in space commerce providing access to, and utilization of the unique environment of space.

Historically, a substantial portion of our revenue has been generated under contracts with NASA, which were subject to periodic funding allocations by the agency. NASA s funding is dependent on receiving annual appropriations from the U.S. Government. During the quarters ended December 31, 2008 and 2007 approximately 23% and 29% of our revenues were generated under NASA contracts, respectively.

Our Astrotech Space Operations subsidiary provides commercial spacecraft launch processing services and payload processing facilities in the U.S. These services are offered at the Astrotech facilities in Titusville, Florida and Vandenberg Air Force Base in California. Additionally, Astrotech supplies payload processing and facilities maintenance support services to Sea Launch Company, LLC for its Sea Launch program at the Home Port facilities in Long Beach, California. Our facilities and services are provided on a fixed price per launch basis.

Our Astrotech Engineering Services subsidiary manages projects in need of comprehensive engineering solutions, and provides unique capabilities such as specialty engineering, hardware design and development, and configuration and data management. Astrotech Engineering Services also designs and fabricates space flight hardware. We continuously review and seek new business opportunities with aerospace and defense contractors, NASA, the Department of Defense, and other governmental agencies, either through prime contracts or teaming with other aerospace companies on new contract bid initiatives.

Through our SPACETECH, Inc. and Astrogenetix (formerly BioSpace) subsidiaries, we are developing commercial applications for space based technologies. SPACETECH is an incubator envisioned to commercialize space-industry technologies into real-world applications to be sold to consumers and industry. The 1st Detect mini-mass spectrometer and the AirWard hazardous cargo containers, both developed by SPACEHAB engineers, are being positioned for entry into the commercial marketplace. Astrogenetix is commercializing the use of microgravity platforms, such as the Space Shuttle and the ISS, for the development of space-made products that are to be sold on Earth. Astrogenetix has successfully processed vaccine samples in space on Space Shuttle Flights, STS-118, STS-123, and STS-124, which have resulted in preliminary salmonella vaccine production data.

Liquidity

As of December 31, 2008, we had cash and restricted cash-on-hand of $7.3 million and our working capital deficit was approximately $0.3 million. Restricted cash, which consists of advance payments on a government contract to modify certain spacecraft processing facilities and restricted deposits relating to bank covenants, totaled $7.1 million at December 31, 2008. We carry a liability of $4.0 million for obligations under this construction contract.

In February 2008 (see Note 5), we consummated a financing facility with a commercial bank. This facility provides for a three year $4.0 million term loan, payable in monthly installments of principal in the amount of $22,222 plus interest and a $2.0 million revolving credit facility. The term loan is secured by the assets of our Astrotech subsidiary and the one-year revolving credit facility is secured by Astrotech s accounts receivable. In February 2009 we renewed the revolving credit facility until February 6, 2010. As of December 31, 2008, no amounts were outstanding under the revolving credit facility.

We believe we have sufficient liquidity and backlog to fund ongoing operations for at least the next fiscal year and expect to utilize existing cash and proceeds from operations to support strategies for new business initiatives.

2. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting of only normal recurring accruals necessary, for a fair presentation of the consolidated financial position of SPACEHAB, Incorporated and its subsidiaries as of December 31, 2008, and the results of its operations and cash flows for the periods ended December 31, 2008 and 2007. However, the unaudited condensed consolidated financial statements do not include all related footnote disclosures.

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The consolidated results of operations for the six month period ended December 31, 2008, are not necessarily indicative of the results that may be expected for the full year. Our results of operations typically fluctuate significantly from quarter to quarter. The interim unaudited condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements appearing in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

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

3. Loss per Share

The following is a reconciliation of the numerator and denominator of the basic and diluted loss per share computations for the three and six month periods ended December 31, 2008 and December 31, 2007 (in thousands, except share and per share data):

	Three months ended December 31, 2008			Three months ended December 31, 2007		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted EPS:						
Net Loss	$ (1,554)	16,392,718	$ (0.09)	$ (32,843)	8,293,710	$ (3.96)
Deemed Dividend Related to Induced Conversion of Preferred Shares				(3,344)		
Net Loss Applicable to Common Shares	$ (1,554)	16,392,718	$ (0.09)	$ (36,187)	8,293,710	$ (4.36)

	Six months ended December 31, 2008			Six months ended December 31, 2007		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted EPS:						
Net Loss	$ (1,499)	16,250,871	$ (0.09)	$ (33,699)	4,798,215	$ (7.02)
Deemed Dividends Related to Induced Conversion of Preferred Shares				(3,344)		
Net Loss Applicable to Common Stock	$ (1,499)	16,250,871	$ (0.09)	$ (37,043)	4,798,215	$ (7.72)

Senior convertible notes payable outstanding as of December 31, 2007, due 2010 convertible into 459,133 shares of common stock at $15.00 per share, which include a mandatory conversion feature once the Company s stock price reaches $19.50 per share, have not been included in the computation of diluted EPS for the three months and six months ended December 31, 2007, as the conversion price(s) of the convertible notes payable per share were greater than the average market price of the shares during the period and no value has been assigned to the mandatory conversion feature.

Options to purchase 1,194,591 shares of common stock outstanding at December 31, 2008, were not included in diluted EPS for the three months and six months ended December 31, 2008, as they were anti-dilutive due to our net loss. The options expire between March 31, 2009 and December 1, 2018.

Options to purchase 97,900 shares of common stock outstanding at December 31, 2007, were not included in diluted EPS for the three months and six months ended December 31, 2007, as they were anti-dilutive due to our net loss. The options expire between July 1, 2008 and December 12, 2016.

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4. Revenue Recognition

Our business units revenue is derived primarily from contracts with the U.S. Government, U.S. Government contractors, and commercial customers. Revenue under these contracts is recognized using the methods described on the following page. Estimating future costs and, therefore, revenues and profits is a process requiring management judgment. Management bases its estimate on historical experience and on various assumptions that are believed to be reasonable under the circumstances including the negotiation(s) of equitable adjustment(s) and change orders on the Cargo Mission Contract (CMC) that are added to the contract as pricing amendment(s) due to delay(s) in the space shuttle launch schedule and customer directed changes to the baseline contracted mission. Costs to complete include, when appropriate, material, labor, subcontracting costs, lease costs, commissions, insurance, and depreciation. Our business segment personnel perform periodic contract status and performance reviews. In the event of a change in total estimated contract cost or profit, the cumulative effect of such change is recorded in the period that the change in estimate occurs.

We, from time to time, make expenditures for specific enhancements and/or additions to our facilities as required by certain contracts where the customer agrees to reimburse us for all or substantially all of such expenditures. We account for such reimbursements as a reduction in the cost of such investments and recognize any excess of such reimbursements over the required investment as revenue.

A Summary of Revenue Recognition Methods Follows:

Business Segment	Services/Products Provided	Contract Type	Method of Revenue Recognition
SPACEHAB Flight Services	Commercial Space Habitat Modules, Integration & Operations Support Services	Firm Fixed Price	Percentage-of-completion based on costs incurred
Astrotech Space Operations	Payload Processing Facilities	Firm Fixed Price Mission Specific	Ratably, over the occupancy period of a satellite within the facility from arrival through launch
		Firm Fixed Price Guaranteed Number of Missions	Ratably, for multi-year contract payments recognized over the contract period
Astrotech Engineering Services	Configuration Management, Engineering Services	Cost Plus Award/Fixed Fee	Earned as reimbursable costs incurred plus award/fixed fee

Revenue for Astrotech Space Operations recognized under a building modification contract with a government agency (see Note 12) is being accounted for under the percentage-of-completion method based on costs incurred over the period of the agreement.

5. Long Term Debt

Credit Facilities

On February 6, 2008, we entered into a financing facility with a bank providing a $4.0 million term loan terminating February 2011 and a $2.0 million revolving credit facility terminating in February 2009. The term loan requires monthly payments of principal totaling $22,222, plus interest at the rate of prime plus 1.75% and the revolving credit facility incurs interest at the rate of prime plus 1.75% (5% at December 31, 2008). Funds available under the revolving credit facility are limited to 80% of eligible accounts receivable. Effective February 6, 2009, we renewed the $2.0 million revolving credit facility for an additional one-year period expiring February 2010. The bank financing facilities are secured by the assets of our Astrotech Space Operations Florida facilities and other covenants including a minimum tangible net worth covenant, a cash flow coverage covenant, a debt service coverage ratio, and a ratio of total liabilities to tangible net worth covenant. In addition, the covenants require us to restrict a $0.6

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million deposit account balance. The balance of the $4.0 million term loan at December 31, 2008, was $3.7 million. No amounts were outstanding on the $2.0 million revolving credit facility as of December 31, 2008 and June 30, 2008.

Senior Convertible Subordinated Notes Payable

The Company s 5.5% Senior Convertible Notes payable mature on October 15, 2010 and pay interest on April 15 and October 15 annually. On October 31, 2008, the Company repurchased $1,750,000 principal amount of its Senior Convertible Notes (see Note 14).

6. Fair Value of Financial Instruments

In general, fair values utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. The following table presents the carrying amounts and estimated fair values of certain of the Company s financial instruments as of December 31, 2008 and June 30, 2008 in accordance with SFAS No. 107, Disclosures about Fair Value of Financial Instruments (in thousands):

	December 31, 2008		June 30, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Term Loan Payable	$ 3,700	$ 3,700	$ 3,793	$ 3,793
Senior Convertible Notes Payable 5.5%	$ 5,111	$ 3,169	$ 6,861	$ 3,775

The fair value of our long term debt is based on quoted market prices, or is estimated based on the current rates offered to us for debt of similar remaining maturities and other terms. The carrying amounts of cash and cash equivalents, investments, accounts receivable, accounts payable, and accrued expenses approximate their fair market value because of the relatively short duration of these instruments.

7. Business and Credit Risk Concentration

Historically, a substantial portion of our revenue has been generated under contracts with NASA, which were subject to period funding allocations by the agency. NASA s funding is dependent on receiving annual appropriations from the U.S. Government. During the six month periods ended December 31, 2008 and 2007, approximately 23% and 29%, respectively, of our revenues were generated under U.S. Government contracts. Of the accounts receivable balance as of December 31, 2008, totaling $4.8 million, 73% of the balance is attributed to three customers. For June 30, 2008, the $3.9 million of receivables was comprised of $3.0 million or 77% from the same three customers.

We maintain our cash primarily with major U.S. domestic banks and other financial institutions. The amounts held in interest bearing accounts periodically exceed the insured limit of $250,000 ($100,000 at June 30, 2008) and exceeded that balance as of December 31, 2008 by $1.8 million and at June 30, 2008 by $6.3 million. The terms of other deposits are on demand and are subject to guarantees in full by the FDIC under the Transaction Account Guarantee Program.

In addition, on December, 31, 2008, we held an investment account of $4.1 million with a financial institution other than a bank. These funds are invested in money market funds. We have not incurred losses related to these deposits.

8. Segment Information

Based on our organization for the second quarter of fiscal year 2009, we operated in three business segments: SPACEHAB Flight Services (Flight Services), Astrotech Space Operations (Astrotech) and Astrotech Engineering Services (Engineering Services). Our Flight Services business segment was founded to commercially develop space habitat modules that operate in the cargo bay of the space shuttles. Flight Services provided access to the modules and integration and operations support services for both NASA and commercial customers. We completed our last manifested space shuttle mission utilizing our space habitat modules in the first quarter of fiscal year 2008. Astrotech provides payload processing facilities and services to serve the spacecraft manufacturing and launch services industries. Engineering Services is primarily engaged in providing engineering services and products to the Government, including NASA.

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Our chief operating decision maker utilizes both revenue and loss before income taxes, depreciation and amortization in assessing performance and making overall operating decisions and resource allocations.

Three Months Ended December 31, 2008 (in thousands):

	Revenue	Income (loss) before income taxes	Net Fixed Assets	Depreciation and Amortization
Flight Services	$ 1	$ (1,083)	$ 247	$ 0
Astrotech	3,695	678	39,887	544
Engineering Services	90	(9)		
Corporate and Other		(1,140)	166	27
	$ 3,786	$ (1,554)	$ 40,300	$ 571

Three Months Ended December 31, 2007 (in thousands):

	Revenue	Income (loss) before income taxes	Net Fixed Assets	Depreciation and Amortization
Flight Services	$ 498	$ (1,282)	$ 282	$ 13
Astrotech	2,438	296	41,737	531
Engineering Services	1,374	170		
Corporate and Other		(32,027)	487	29
	$ 4,310	$ (32,843)	$ 42,506	$ 573

Six Months Ended December 31, 2008 (in thousands):

	Revenue	Income (loss) before income taxes	Net Fixed Assets	Depreciation And Amortization
Flight Services	$ 195	$ (1,924)	$ 247	$ 15
Astrotech	9,399	2,959	39,887	1,048
Engineering Services	166	(16)		
Corporate and Other		(2,518)	166	67
	$ 9,760	$ (1,499)	$ 40,300	$ 1,129

Six Months Ended December 31, 2007 (in thousands):

	Revenue	Income (loss) before income taxes	Net Fixed Assets	Depreciation And Amortization

Flight Services	$	4,081	$	(1,072)	$	282	$	435
Astrotech		6,150		1,653		41,737		1,063
Engineering Services		2,675		314				
Corporate and Other				(34,594)		487		111
	$	12,906	$	(33,699)	$	42,506	$	1,561

9. Common Stock Options, Stock Purchase Plans and Other Long Term Incentive Plans

We grant options to employees and directors utilizing three shareholder-approved plans and issue Company stock under an Employee Stock Purchase Plan. Stock options and other equity awards are granted at the sole discretion of the Compensation Committee of the Board of Directors. The number and price of the options granted are specifically defined by the Compensation Committee at the time of each award. Such options typically vest incrementally over a period of four years and generally expire within ten years of the date of grant. Equity awards are valued at the closing bid price for the Company s stock on the day of grant. As of December 31, 2008, there were 2,567,063 shares available for future grant under the Company s shareholder approved plans.

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The 1994 Stock Incentive Plan

Under the terms of the 1994 Plan, the number and price of the options granted to employees is determined by the Board of Directors and such options vest, in most cases, incrementally over a period of four years and expire no more than ten years after the date of grant. The total number of shares that are available under this plan is 395,000. As of December 31, 2008, there are 157,619 available for grant.

The Directors Stock Option Plan

Prior to suspension of the Directors Stock Option Plan in January 2008, each new non-employee director received a one-time grant of an option to purchase 1,000 shares of common stock at an exercise price equal to the fair market value on the date of grant. In addition, effective as of the date of each annual meeting of our stockholders, each non-employee director who was elected or continued as a member of the Board of Directors of the Company was awarded an option to purchase 500 shares of common stock. Options under the Director s Plan vest after one year and expire seven years from the date of grant. The total number of options that are available under this plan is 50,000. As of December 31, 2008, there are 22,000 available for grant.

1997 Employee Stock Purchase Plan

We adopted an employee stock purchase plan that permits eligible employees to purchase shares of common stock of the Company at prices no less than 85% of the current market price. Eligible employees may elect to participate in the plan by authorizing payroll deductions from 1% to 10% of gross compensation for each payroll period. On the last day of each quarter, each participant s contribution account is used to purchase the maximum number of whole and fractional shares of common stock determined by dividing the contribution account s balance by the lesser of 85% of the price of a share of common stock on the first day of the quarter or the last day of a quarter. The number of shares of common stock that may be purchased under the plan is 150,000. Through December 31, 2008, employees have purchased 148,265 shares under this plan. During the fourth quarter of fiscal year 2007, we suspended purchases under this plan. The shares purchased under this plan are considered compensatory for accounting and reporting purposes.

2008 Stock Incentive Plan (2008 Plan)

On March 27, 2008 the stockholders of the Company approved the 2008 Stock Incentive Plan. The purpose of the 2008 Plan is to foster and promote the long-term financial success of the Company, and to increase shareholder value by attracting, motivating, and retaining key employees, consultants, and directors and providing such participants in the 2008 Plan with a program for obtaining an ownership interest in the Company that links and aligns their personal interests with the Company s stockholders. The 2008 Plan authorizes grants of stock compensation, restricted stock, stock options, performance units, and other equity based performance awards. The total number of shares that are available under the 2008 Plan is 5,500,000. During the three months ended December 31, 2008, 297,583 options net of cancellations were granted to employees. As of December 31, 2008, there were 2,385,709 shares available for future grant.

Other Stock Based Incentive Awards

- Special performance shares We issued 62,200 performance shares on December 21, 2007, that vest on January 15, 2009, subject to certain events or upon designation by the Compensation Committee. Termination of employment, except for resignation or cause was not an event of forfeiture. The employees receiving special performance shares were subsequently terminated by the Company and the risk of subsequent forfeiture was not material. Consequently, we expensed the entire fair value of the grant $127,510 in the three months ended December 31 of fiscal year 2008 valuing the performance shares at the close of business on the date of grant. Subsequently, 9,750 shares have been forfeited and the stock price has decreased from $2.05 to $0.26 resulting in recovery of $5,245 in the three months ended December 31, 2008.

- 2007 performance shares We issued 239,900 performance shares on December 21, 2007, that vest on February 15, 2011 subject to certain events or upon designation by the Compensation Committee. Termination of employment for any cause is an event of forfeiture. We valued the 2007 performance shares granted at the close of business on the date of grant, and recognize expense and accrue an incentive compensation liability, pro rata over the vesting period. 126,000 shares were subsequently forfeited and the stock price decreased from $2.05 to $0.26 which allowed for a recovery of expense in the amount of $935 for the three months ended December 31, 2008.

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• Restricted stock grants On March 27, 2008 the Board of Directors granted 25,000 shares of restricted stock to each non-employee director of the Company. The Restricted Stock vests annually over a period of four years and unvested shares are forfeited if the director leaves the Board of Directors prior to the vesting date. On July 18, 2008, the Board of Directors granted a total of 400,000 shares of restricted stock to its named executive officers. The restricted stock vests 50% on January 15, 2009, 25% on January 15, 2010, and 25% on January 15, 2011. In the three months ended December 31, 2008, we recognized compensation and director fee expense of $70,691 for restricted stock grants.

• Other equity awards On July 18, 2008, the Board of Directors granted an award of 1,100,000 shares of unrestricted common stock to Mr. Thomas B. Pickens, III, the Company s Chief Executive Officer, 200,000 shares of unrestricted common stock to Mr. Barry A. Williamson, a director, and 150,000 shares of unrestricted common stock to Mr. Mark E. Adams, a director. Such grants of unrestricted common stock were made from the 2008 Plan and compensation expense of $1,002,500 was recognized in fiscal year 2008.

Cash Based Long Term Incentive Awards

In December 2007 the Compensation Committee of the Board of Directors adopted and implemented a Long Term Cash Incentive plan. The plan makes cash incentive awards to employees based on the successful completion of certain events and passage of time as established by the Committee. These units vest on February 15, 2011 and are subject to material risk of forfeiture. The Committee has granted such awards to employees valued at $344,900. As of December 31, 2008, the Company had a remaining commitment for such awards of $161,900. We have accrued $57,441 towards this future commitment.

Accounting for Stock Issued to Employees

The fair value of each option award is estimated on the date of grant using the Black Scholes option pricing model, which determines inputs as shown in the following table.

	December 31, 2008		**December 31,**
	2-Year Options	**10-Year Options**	**2007***
Expected Dividend Yield	0	0	N/A
Expected Volatility	1.15	1.15	N/A
Risk Free Interest Rates	0.36%	1.76%	N/A
Expected Option Life (in years)	0.58	6.25	N/A

*No options were issued for the period ended December 31, 2007

Because of differences in option terms and historical exercise patterns among the plans, we have segregated option awards into three homogenous groups for the purpose of determining fair values for options. Valuation assumptions are determined separately for the three groups that represent, respectively, options with a term of 2 years, options generally with a term of 10 years, and options under the Directors Stock Option Plan that generally have a term of 7 years. The assumptions are as follows:

- We estimated volatility using our historical share price performance over the last ten years. Management considered the guidance in SFAS No. 123R and believes the historical estimated volatility is materially indicative of expectations about expected future volatility.

- We use the simplified method outlined in the Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 107 to estimate expected lives for options granted.

- The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

- The expected dividend yield is based on our current dividend yield and the best estimate of projected dividend yield for future periods within the expected life of the option, which is zero.

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A summary of our stock option activity as of December 31, 2008, and changes during the first six months of fiscal year 2009 are presented in the following table:

	Shares Under Fixed Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at June 30, 2008	85,400	$ 26.48	3.65	$
Granted				