WILLIAMS COMPANIES INC
Form 10-K
February 25, 2009

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year 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 1-4174
The Williams Companies, Inc.
(Exact name of Registrant as Specified in Its Charter)

Delaware	**73-0569878**
(State or Other Jurisdiction of Incorporation or Organization)	*(IRS Employer Identification No.)*
One Williams Center, Tulsa, Oklahoma	**74172**
(Address of Principal Executive Offices)	*(Zip Code)*

918-573-2000
(Registrant s Telephone Number, Including Area Code)

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $1.00 par value	New York Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
5.50% Junior Subordinated Convertible Debentures due 2033

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, as of the last business day of the registrant s most recently completed second quarter was approximately $23,344,993,927.

The number of shares outstanding of the registrant s common stock outstanding at February 19, 2009 was 579,213,365.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s Definitive Proxy Statement for the Registrant s 2009 Annual Meeting of Stockholders to be held on May 21, 2009, are incorporated into Part III, as specifically set forth in Part III.

THE WILLIAMS COMPANIES, INC.
FORM 10-K

TABLE OF CONTENTS

Table of Contents

DEFINITIONS

We use the following oil and gas measurements in this report:

Bcfe means one billion cubic feet of gas equivalent determined using the ratio of one barrel of oil or condensate to six thousand cubic feet of natural gas.

Bcf/d means one billion cubic feet per day.

British Thermal Unit or BTU means a unit of energy needed to raise the temperature of one pound of water by one degree Fahrenheit.

BBtud means one billion BTUs per day.

Dekatherms or Dth or Dt means a unit of energy equal to one million BTUs.

Mbbls/d means one thousand barrels per day.

Mcfe means one thousand cubic feet of gas equivalent using the ratio of one barrel of oil or condensate to six thousand cubic feet of natural gas.

Mdt/d means one thousand dekatherms per day.

MMcf means one million cubic feet.

MMcf/d means one million cubic feet per day.

MMcfe means one million cubic feet of gas equivalent using the ratio of one barrel of oil or condensate to six thousand cubic feet of natural gas.

MMdt means one million dekatherms or approximately one trillion BTUs.

MMdt/d means one million dekatherms per day.

TBtu means one trillion BTUs.

Table of Contents

PART I

Item 1. *Business*

In this report, Williams (which includes The Williams Companies, Inc. and, unless the context otherwise requires, all of our subsidiaries) is at times referred to in the first person as we, us or our. We also sometimes refer to Williams as the Company.

WEBSITE ACCESS TO REPORTS AND OTHER INFORMATION

We file our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and other documents electronically with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended (Exchange Act). You may read and copy any materials that we file with the SEC at the SEC s Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You may also obtain such reports from the SEC s Internet website at *http://www.sec.gov.*

Our Internet website is *http://www.williams.com.* We make available free of charge on or through our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our Corporate Governance Guidelines, Code of Ethics, Board Committee Charters and Code of Business Conduct are also available on our Internet website. We will also provide, free of charge, a copy of any of our corporate documents listed above upon written request to our Corporate Secretary, One Williams Center, Suite 4700, Tulsa, Oklahoma 74172.

GENERAL

We are a natural gas company originally incorporated under the laws of the state of Nevada in 1949 and reincorporated under the laws of the state of Delaware in 1987. We were founded in 1908 when two Williams brothers began a construction company in Fort Smith, Arkansas. Today, we primarily find, produce, gather, process and transport natural gas. Our operations are concentrated in the Pacific Northwest, Rocky Mountains, Gulf Coast, the Eastern Seaboard, and the province of Alberta in Canada.

Our principal executive offices are located at One Williams Center, Tulsa, Oklahoma 74172. Our telephone number is 918-573-2000.

In 2008, we used Economic Value Added® (EVA®)[1] as the basis for disciplined decision making around the use of capital. EVA® is a tool that considers both financial earnings and a cost of capital in measuring performance. It is based on the idea that earning profits from an economic perspective requires that a company cover not only all of its operating expenses but also all of its capital costs. The two main components of EVA® are net operating profit after taxes and a charge for the opportunity cost of capital. We derive these amounts by making various adjustments to our reported results and financial position, and by applying a cost of capital. We look for opportunities to improve EVA® because we believe there is a strong correlation between EVA® improvement and creation of shareholder value.

FINANCIAL INFORMATION ABOUT SEGMENTS

See Item 8 Financial Statements and Supplementary Data Notes to Consolidated Financial Statements Note 18 of our Notes to Consolidated Financial Statements for information with respect to each segment s revenues, profits or losses and total assets.

[1] Economic Value Added® (EVA®) is a registered trademark of Stern, Stewart & Co.

Table of Contents

BUSINESS SEGMENTS

Substantially all our operations are conducted through our subsidiaries. To achieve organizational and operating efficiencies, our activities are primarily operated through the following business segments:

Exploration & Production produces, develops and manages natural gas reserves primarily located in the Rocky Mountain and Mid-Continent regions of the United States and is comprised of several wholly owned and partially owned subsidiaries including Williams Production Company LLC and Williams Production RMT Company (RMT).

Gas Pipeline includes our interstate natural gas pipelines and pipeline joint venture investments organized under our wholly owned subsidiary, Williams Gas Pipeline Company, LLC (WGP). Gas Pipeline also includes Williams Pipeline Partners L.P. (WMZ), our master limited partnership formed in 2007.

Midstream Gas & Liquids includes our natural gas gathering, treating and processing business and is comprised of several wholly owned and partially owned subsidiaries including Williams Field Services Group LLC and Williams Natural Gas Liquids, Inc. Midstream also includes Williams Partners L.P. (WPZ), our master limited partnership formed in 2005.

Gas Marketing Services manages our natural gas commodity risk through purchases, sales and other related transactions, under our wholly owned subsidiary Williams Gas Marketing, Inc.

Other primarily consists of corporate operations.

This report is organized to reflect this structure.

Detailed discussion of each of our business segments follows.

Exploration & Production

Our Exploration & Production segment produces, develops, and manages natural gas reserves primarily located in the Rocky Mountain (primarily New Mexico, Wyoming and Colorado) and Mid-Continent (Oklahoma and Texas) regions of the United States. We specialize in natural gas production from tight-sands and shale formations and coal bed methane reserves in the Piceance, San Juan, Powder River, Arkoma, Green River and Fort Worth basins. Over 99 percent of Exploration & Production s domestic reserves are natural gas. Our Exploration & Production segment also has international oil and gas interests, which include a 69 percent equity interest in Apco Argentina Inc., an oil and gas exploration and production company with operations in Argentina, and a 4 percent equity interest in Petrowayu S.A., a Venezuelan corporation that is the operator of a 100 percent interest in the La Concepcion block located in western Venezuela.

Exploration & Production s current proved undeveloped and probable reserves provide us with strong capital investment opportunities for several years into the future. Exploration & Production s goal is to drill its existing proved undeveloped reserves, which is comprised of approximately 43 percent of proved reserves, and to drill in areas of probable reserves adding to our proved reserves. In addition, Exploration & Production provides a significant amount of equity production that is gathered and/or processed by our Midstream facilities in the San Juan basin.

Information for our Exploration & Production segment relates only to domestic activity unless otherwise noted. We use the terms gross to refer to all wells or acreage in which we have at least a partial working interest and net to refer to our ownership represented by that working interest.

Table of Contents

Gas reserves and wells

The following table summarizes our U.S. natural gas reserves as of December 31 (using market prices on December 31 held constant) for the year indicated:

	2008	**2007**	**2006**
		(Bcfe)	
Proved developed natural gas reserves	2,456	2,252	1,945
Proved undeveloped natural gas reserves	1,883	1,891	1,756
Total proved natural gas reserves	4,339	4,143	3,701

No major discovery or other favorable or adverse event has caused a significant change in estimated gas reserves since year-end 2008. We have not filed on a recurring basis estimates of our total proved net oil and gas reserves with any U.S. regulatory authority or agency other than the Department of Energy (DOE) and the SEC. The estimates furnished to the DOE have been consistent with those furnished to the SEC, although Exploration & Production has not yet been required to file any information with respect to its estimated total reserves at December 31, 2008 with the DOE. Certain estimates filed with the DOE may not necessarily be directly comparable to those reported here due to special DOE reporting requirements, such as the requirement to report gross operated reserves only. In 2007 and 2006, the underlying estimated reserves for the DOE did not differ by more than 5 percent from the underlying estimated reserves utilized in preparing the estimated reserves reported to the SEC.

Approximately 99 percent of our year-end 2008 United States proved reserves estimates were audited in each separate basin by Netherland, Sewell & Associates, Inc. (NSAI). When compared on a well-by-well basis, some of our estimates are greater and some are less than the estimates of NSAI. However, in the opinion of NSAI, the estimates of our proved reserves are in the aggregate reasonable by basin and have been prepared in accordance with generally accepted petroleum engineering and evaluation principles. These principles are set forth in the Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information promulgated by the Society of Petroleum Engineers. NSAI is satisfied with our methods and procedures in preparing the December 31, 2008 reserve estimates and saw nothing of an unusual nature that would cause NSAI to take exception with the estimates, in the aggregate, as prepared by us. Reserve estimates related to properties underlying the Williams Coal Seam Gas Royalty Trust, which comprise approximately 1 percent of our total U.S. proved reserves, were prepared by Miller and Lents, LTD.

The SEC has revised its oil and gas reporting requirements effective for fiscal years ending on or after December 31, 2009, with early adoption prohibited. These changes include:

- Expanding the definition of oil and gas reserves and providing clarification of certain concepts and technologies used in the reserve estimation process.

- Allowing optional disclosure of probable and possible reserves and permitting optional disclosure of price sensitivity analysis.

- Modifying prices used to estimate reserves for SEC disclosure purposes to a 12-month average price instead of a single-day, period-end price.

Requiring certain additional disclosures around proved undeveloped reserves, internal controls used to ensure objectivity of the estimation process, and qualifications of those preparing and/or auditing the reserves.

Table of Contents

Oil and gas properties and reserves by basin

The table below summarizes 2008 activity and reserves for each of our areas, with further discussion following the table.

	Wells Drilled (Gross)	Wells Drilled (Operated)	Wells Producing (Gross)	Wells Producing (Net)	Wellhead Production (Net Bcfe)	Proved Reserves (Bcfe)	% of Total Proved Reserves
Piceance	687	646	3,163	2,894	238	3,095	71%
San Juan	95	37	3,129	852	55	523	12%
Powder River	703	366	5,407	2,465	84	390	9%
Mid-Continent	82	76	672	434	25	224	5%
Other	220	0	611	21	4	107	3%
Total	1,787	1,125	12,982	6,666	406	4,339	100%

Piceance basin

The Piceance basin is located in northwestern Colorado and is our largest area of concentrated development. During 2008 we operated an average of 26 drilling rigs in the basin. As of December 31, 2008, 15 of these rigs were the new high efficiency rigs designed to drill up to 22 wells from one location. This area has approximately 1,770 undrilled proved locations in inventory. Within this basin we own and operate natural gas gathering facilities including some 300 miles of gathering lines and associated field compression. Approximately 85 percent of the gas gathered is our own equity production. The gathering system also includes 7 processing plants and associated treating facilities with an eighth plant that came on-line in February 2009, for a total capacity of 1.25 Bcfd. During 2008, these plants recovered approximately 69 million gallons of natural gas liquids (NGLs) which were marketed separately from the residue natural gas.

San Juan basin

The San Juan basin is located in northwest New Mexico and southwest Colorado.

Powder River basin

The Powder River basin is located in northeast Wyoming. The Powder River basin includes large areas with multiple coal seam potential, targeting thick coal bed methane formations at shallow depths. We have a significant inventory of undrilled locations, providing long-term drilling opportunities.

Mid-Continent properties

The Mid-Continent properties are located in the southeastern Oklahoma portion of the Arkoma basin and the Barnett Shale in the Fort Worth basin of Texas.

Other properties

Other properties are primarily comprised of interests in the Green River basin in southwestern Wyoming. Also included is exploration activity and other miscellaneous activity.

The following table summarizes our leased acreage as of December 31, 2008:

	Gross Acres	Net Acres
Developed	981,853	512,896
Undeveloped	1,269,350	661,568

Table of Contents

Operating statistics

We focus on lower-risk development drilling. Our development drilling success rate was approximately 99 percent in each of 2008, 2007 and 2006. The following table summarizes domestic drilling activity by number and type of well for the periods indicated:

Number of Wells	Gross Wells	Net Wells
Development:		
Drilled		
2008	1,783	1,050
2007	1,590	904
2006	1,783	954
Successful		
2008	1,782	1,050
2007	1,581	899
2006	1,770	948

We also successfully drilled four exploratory wells in 2008. In addition, two exploratory wells drilled in prior years were determined to be unsuccessful in 2008.

Because we currently have a low-risk drilling program in proven basins, the main component of risk that we manage is price risk. Exploration & Production natural gas hedges for 2009 domestic natural gas production consist of NYMEX fixed price contracts of 106 MMcf/d (whole year) and approximately 490 MMcf/d in regional collars (whole year). Our natural gas production hedges in 2008 consisted of 70 MMcf/d in NYMEX fixed price hedges and 434 MMcf/d in regional collars. A collar is an option contract that sets a gas price floor and ceiling for a certain volume of natural gas. Hedging decisions are made considering the overall Williams commodity risk exposure and are not executed independently by Exploration & Production; there are expected future gas purchases for other Williams entities that when taken as a net position may offset price risk related to Exploration & Production s expected future gas sales. In February 2007, we entered into a five-year unsecured credit agreement with certain banks in order to reduce margin requirements related to our hedging activities as well as lower transaction fees. Margin requirements, if any, under this new facility are dependent on the level of hedging with the banks and on natural gas reserves value. In June 2008, we amended this agreement to extend the facility through year end 2013.

The following table summarizes our domestic sales and cost information for the years indicated:

	2008	2007	2006
Total net production sold (in Bcfe)	400.4	333.1	274.4
Average production costs including production taxes per (Mcfe) produced	$ 1.26	$ 0.98	$ 1.02
Average sales price per Mcfe	$ 6.39	$ 4.92	$ 5.24
Realized gain (loss) on hedging contracts	$ 0.09	$ 0.16	$ (0.73)

Acquisitions & divestitures

In January 2008, we sold a contractual right to a production payment on certain future international hydrocarbon production for $148 million. As a result of the contract termination, we have no further interests associated with the crude oil concession, which is located in Peru. We obtained these interests through our acquisition of Barrett Resources Corporation in 2001.

In May 2008, we acquired certain undeveloped leasehold acreage, producing properties and gathering facilities in the Piceance basin for $285 million. In July 2008, a third party exercised its contractual option to purchase, on the same terms and conditions, an interest in a portion of the acquired assets for $71 million. We received this $71 million in October 2008.

In September 2008, we increased our position in the Fort Worth basin by acquiring certain undeveloped leasehold acreage and producing properties for $147 million subject to post-closing adjustments. This acquisition is

Table of Contents

consistent with our growth strategy of leveraging our horizontal drilling expertise by acquiring and developing low-risk properties in the Barnett Shale formation.

Through other transactions totaling approximately $111 million, Exploration & Production expanded its acreage position and producing properties in the Fort Worth basin in north-central Texas and also expanded its acreage position in the Highlands area of the Piceance basin and in the Paradox basin.

Other information

In 1993, Exploration & Production conveyed a net profits interest in certain of its properties to the Williams Coal Seam Gas Royalty Trust. Substantially all of the production attributable to the properties conveyed to the trust was from the Fruitland coal formation and constituted coal seam gas. We subsequently sold trust units to the public in an underwritten public offering and retained 3,568,791 trust units then representing 36.8 percent of outstanding trust units. We have previously sold trust units on the open market, with our last sales in June 2005. As of February 1, 2009, we own 789,291 trust units.

International exploration and production interests

We also have investments in international oil and gas interests. If combined with our domestic proved reserves, our international interests would make up approximately 3 percent of our total proved reserves.

Gas Pipeline

We own and operate, a combined total of approximately 14,000 miles of pipelines with a total annual throughput of approximately 2,700 trillion British Thermal Units of natural gas and peak-day delivery capacity of approximately 12 MMdt of gas. Gas Pipeline consists of Transcontinental Gas Pipe Line Company, LLC (Transco) and Northwest Pipeline GP (Northwest Pipeline). Gas Pipeline also holds interests in joint venture interstate and intrastate natural gas pipeline systems including a 50 percent interest in Gulfstream Natural Gas System, L.L.C. Gas Pipeline also includes WMZ.

Transco

Transco is an interstate natural gas transportation company that owns and operates a 10,100-mile natural gas pipeline system extending from Texas, Louisiana, Mississippi and the offshore Gulf of Mexico through Alabama, Georgia, South Carolina, North Carolina, Virginia, Maryland, Pennsylvania, and New Jersey to the New York City metropolitan area. The system serves customers in Texas and 11 southeast and Atlantic seaboard states, including major metropolitan areas in Georgia, North Carolina, Washington, D.C., New York, New Jersey, and Pennsylvania.

Pipeline system and customers

At December 31, 2008, Transco s system had a mainline delivery capacity of approximately 4.7 MMdt of natural gas per day from its production areas to its primary markets. Using its Leidy Line along with market-area storage and transportation capacity, Transco can deliver an additional 3.8 MMdt of natural gas per day for a system-wide delivery capacity total of approximately 8.5 MMdt of natural gas per day. Transco s system includes 45 compressor stations, four underground storage fields, and a liquefied natural gas (LNG) storage facility. Compression facilities at sea level-rated capacity total approximately 1.5 million horsepower.

Transco s major natural gas transportation customers are public utilities and municipalities that provide service to residential, commercial, industrial and electric generation end users. Shippers on Transco s system include public utilities, municipalities, intrastate pipelines, direct industrial users, electrical generators, gas marketers and producers. One customer accounted for approximately 11 percent and another customer accounted for approximately 10 percent of Transco s total revenues in 2008. Transco s firm transportation agreements are generally long-term agreements with various expiration dates and account for the major portion of Transco s business. Additionally, Transco offers storage services and interruptible transportation services under short-term agreements.

Transco has natural gas storage capacity in four underground storage fields located on or near its pipeline system or market areas and operates two of these storage fields. Transco also has storage capacity in an LNG storage facility and operates the facility. The total usable gas storage capacity available to Transco and its customers in such underground storage fields and LNG storage facility and through storage service contracts is approximately 204 billion cubic feet of gas. In October 2008, the FERC approved Transco s request to abandon its Hester storage facility, which is not in operation. Hester is not included in the capacity described above. Storage capacity permits Transco s customers to inject gas into storage during the summer and off-peak periods for delivery during peak winter demand periods.

Transco expansion projects

The pipeline projects listed below are future pipeline projects for which we have customer commitments.

Sentinel Expansion Project

The Sentinel Expansion Project involves an expansion of our existing natural gas transmission system from the Leidy Hub in Clinton County, Pennsylvania and from the Pleasant Valley interconnection with Cove Point LNG in Fairfax County, Virginia to various delivery points requested by the shippers under the project. The capital cost of the project is estimated to be up to approximately $200 million. Phase I was placed into service in December 2008. Phase II is expected to be placed into service by November 2009.

Mobile Bay South Expansion Project

The Mobile Bay South Expansion Project involves the addition of compression at Transco s Station 85 in Choctaw County, Alabama to allow Transco to provide firm transportation service southbound on the Mobile Bay line from Station 85 to various delivery points. The capital cost of the project is estimated to be up to approximately $37 million. Transco plans to place the project into service by May 2010.

85 North Expansion Project

The 85 North Expansion Project involves an expansion of our existing natural gas transmission system from Station 85 in Choctaw County, Alabama to various delivery points as far north as North Carolina. The capital cost of the project is estimated to be $248 million. Transco plans to place the project into service in phases, in July 2010 and May 2011.

Operating statistics

The following table summarizes transportation data for the Transco system for the periods indicated:

	2008	2007	2006
	(In trillion British Thermal Units)		
Market-area deliveries:			
Long-haul transportation	753	839	795
Market-area transportation	969	875	817
Total market-area deliveries	1,722	1,714	1,612
Production-area transportation	188	190	247

Total system deliveries	1,910	1,904	1,859
Average Daily Transportation Volumes	5.2	5.2	5.1
Average Daily Firm Reserved Capacity	6.8	6.6	6.6

Transco s facilities are divided into eight rate zones. Five are located in the production area, and three are located in the market area. Long-haul transportation involves gas that Transco receives in one of the production-area zones and delivers to a market-area zone. Market-area transportation involves gas that Transco both receives and

Table of Contents

delivers within the market-area zones. Production-area transportation involves gas that Transco both receives and delivers within the production-area zones.

Northwest Pipeline

Northwest Pipeline is an interstate natural gas transportation company that owns and operates a natural gas pipeline system extending from the San Juan basin in northwestern New Mexico and southwestern Colorado through Colorado, Utah, Wyoming, Idaho, Oregon and Washington to a point on the Canadian border near Sumas, Washington. Northwest Pipeline provides services for markets in California, Arizona, New Mexico, Colorado, Utah, Nevada, Wyoming, Idaho, Oregon and Washington directly or indirectly through interconnections with other pipelines.

Pipeline system and customers

At December 31, 2008, Northwest Pipeline s system, having long-term firm transportation agreements including peaking service of approximately 3.6 Bcf of natural gas per day, was composed of approximately 3,900 miles of mainline and lateral transmission pipelines and 41 transmission compressor stations having a combined sea level-rated capacity of approximately 473,000 horsepower.

In 2008, Northwest Pipeline served a total of 136 transportation and storage customers. We transport and store natural gas for a broad mix of customers, including local natural gas distribution companies, municipal utilities, direct industrial users, electric power generators and natural gas marketers and producers. The largest customer of Northwest Pipeline in 2008 accounted for approximately 20.7 percent of its total operating revenues. No other customer accounted for more than 10 percent of Northwest Pipeline s total operating revenues in 2008. Northwest Pipeline s firm transportation and storage contracts are generally long-term contracts with various expiration dates and account for the major portion of Northwest Pipeline s business. Additionally, Northwest Pipeline offers interruptible and short-term firm transportation service.

As a part of its transportation services, Northwest Pipeline utilizes underground storage facilities in Utah and Washington enabling it to balance daily receipts and deliveries. Northwest Pipeline also owns and operates an LNG storage facility in Washington that provides service for customers during a few days of extreme demands. These storage facilities have an aggregate firm delivery capacity of approximately 700 MMcf of gas per day.

Northwest Pipeline expansion projects

The pipeline projects listed below were completed during 2008 or are future pipeline projects for which we have customer commitments.

Colorado Hub Connection Project

Northwest Pipeline has proposed installing a new 27-mile, 24-inch diameter lateral to connect the Meeker/White River Hub near Meeker, Colorado to its mainline near Sand Springs, Colorado. This project is referred to as the Colorado Hub Connection (CHC Project). It is estimated that the construction of the CHC Project will cost up to $60 million with service targeted to commence in November 2009. Northwest Pipeline will combine the lateral capacity with 341 MDth per day of existing mainline capacity from various receipt points for delivery to Ignacio, Colorado, including approximately 98 MDth per day of capacity that was sold on a short-term basis. Approximately 243 MDth per day of this capacity is held by Pan-Alberta Gas under a contract that terminates on October 31, 2012.

In addition to providing greater opportunity for contract extensions for the short-term firm and Pan-Alberta capacity, the CHC Project provides direct access to additional natural gas supplies at the Meeker/White River Hub for Northwest Pipeline s on-system and off-system markets. Northwest Pipeline has entered into precedent agreements with terms ranging between eight and fifteen years at maximum rates for all of the short-term firm and Pan-Alberta capacity resulting in the successful re-contracting of the capacity out to 2018 and beyond. In September 2008, Northwest Pipeline filed an application for FERC certification and is awaiting necessary regulatory approvals. If Northwest Pipeline does not proceed with the CHC Project, Northwest

Table of Contents

Pipeline will seek recovery of any shortfall in annual capacity reservation revenues from our remaining customers in a future rate proceeding. Northwest Pipeline does expect to collect maximum rates for the new CHC Project capacity commitments and seek approval to recover the CHC Project costs in any future rate case filed with the FERC.

Sundance Trail Expansion

In February 2008, Northwest Pipeline initiated an open season for the proposed Sundance Trail Expansion project that resulted in the execution of an agreement for 150 MDth per day of firm transportation service from the Meeker/White River Hub in Colorado for delivery to the Opal Hub in Wyoming. The project will include construction of approximately 16 miles of 30-inch loop between Northwest Pipeline s existing Green River and Muddy Creek compressor stations in Wyoming as well as an upgrade to Northwest Pipeline s existing Vernal compressor station, with service targeted to commence in November 2010. The total project is estimated to cost up to $65 million, including the cost of replacing existing compression at the Vernal compressor station which will enhance the efficiency of Northwest Pipeline s system. The Sundance Trail Expansion will utilize available capacity on the CHC lateral and the existing Piceance lateral in conjunction with available and expanded mainline capacity. The Sundance Trail Expansion remains subject to certain conditions, including receiving the necessary regulatory approvals. Northwest Pipeline expects to collect maximum system rates, and will seek approval to roll-in the Sundance Trail Expansion costs in any future rate case filed with the FERC.

Operating statistics

The following table summarizes volume and capacity data for the Northwest Pipeline system for the periods indicated:

	2008	2007	2006
	(In trillion British Thermal Units)		
Total Transportation Volume	781	757	676
Average Daily Transportation Volumes	2.1	2.1	1.8
Average Daily Reserved Capacity Under Long-Term Base Firm Contracts, excluding peak capacity	2.5	2.5	2.5
Average Daily Reserved Capacity Under Short-Term Firm Contracts(1)	.7	.8	.9

(1) Consists primarily of additional capacity created from time to time through the installation of new receipt or delivery points or the segmentation of existing mainline capacity. Such capacity is generally marketed on a short-term firm basis.

Gulfstream Natural Gas System, L.L.C. (Gulfstream)

Gulfstream is a natural gas pipeline system extending from the Mobile Bay area in Alabama to markets in Florida. Gas Pipeline and Spectra Energy, through their respective subsidiaries, each holds a 50 percent ownership interest in Gulfstream and provides operating services for Gulfstream. At December 31, 2008, our equity investment in Gulfstream was $525 million.

Gulfstream expansion projects

Gulfstream placed the Phase III expansion project in service on September 1, 2008. The project extended the pipeline system into South Florida and fully subscribed the remaining 345 Mdt/d of firm capacity on the existing pipeline system on a long-term basis. The estimated capital cost of this project is $118 million, with Gas Pipeline s share being 50 percent of such costs. Service under the Gulfstream Phase IV expansion project began during the fourth quarter of 2008. The project is fully subscribed on a long-term basis and is the first incremental expansion of Gulfstream s mainline capacity. The estimated capital cost of this expansion is $192 million, with Gas Pipeline s share being 50 percent of such costs.

WMZ

WMZ was formed to own and operate natural gas transportation and storage assets. We currently own an approximate 45.7 percent limited partnership interest and a 2 percent general partner interest in WMZ. WMZ provides us with lower cost of capital that is expected to enable growth of our Gas Pipeline business. WMZ also creates a vehicle to monetize our qualifying assets. Such transactions, which are subject to approval by the boards of directors of Williams and WMZ s general partner, allow us to retain control of the assets through our ownership interest in WMZ. A subsidiary of ours, Williams Pipeline GP LLC, serves as the general partner of WMZ. The initial asset of WMZ is a 35 percent interest in Northwest Pipeline.

Midstream Gas & Liquids

Our Midstream segment, one of the nation s largest natural gas gatherers and processors, has primary service areas concentrated in major producing basins in Colorado, New Mexico, Wyoming, the Gulf of Mexico, Venezuela and western Canada. Midstream s primary businesses natural gas gathering, treating, and processing; NGL fractionation, storage and transportation; and oil transportation fall within the middle of the process of taking natural gas and crude oil from the wellhead to the consumer. NGLs, ethylene and propylene are extracted/produced at our plants, including our Canadian and Gulf Coast olefins plants. These products are used primarily for the manufacture of petrochemicals, home heating fuels and refinery feedstock.

Some of our assets are owned through our interest in WPZ.

Key variables for our business will continue to be:

- Retaining and attracting customers by continuing to provide reliable services;
- Revenue growth associated with additional infrastructure either completed or currently under construction;
- Disciplined growth in our core service areas and new step-out areas;
- Prices impacting our commodity-based processing and olefin activities.

Domestic gathering, processing and treating

Our domestic gathering systems receive natural gas from producers oil and natural gas wells and gather these volumes to gas processing, treating or redelivery facilities. Typically, natural gas, in its raw form, is not acceptable for transportation in major interstate natural gas pipelines or for commercial use as a fuel. In addition, natural gas contains various amounts of NGLs, which generally have a higher value when separated from the natural gas stream. Our processing and treating plants remove water vapor, carbon dioxide and other contaminants and our processing plants extract the NGLs. NGL products include:

- Ethane, primarily used in the petrochemical industry as a feedstock for ethylene production, one of the basic building blocks for plastics;
- Propane, used for heating, fuel and as a petrochemical feedstock in the production of ethylene and propylene, another building block for petrochemical-based products such as carpets, packing materials and molded plastic parts;

Normal butane, iso-butane and natural gasoline, primarily used by the refining industry as blending stocks for motor gasoline or as a petrochemical feedstock.

Although a significant portion of our gas processing services are performed for a volumetric-based fee, a portion of our gas processing agreements are commodity-based and include two distinct types of commodity exposure. The first type includes keep whole processing agreements whereby we own the rights to the value from NGLs recovered at our plants and have the obligation to replace the lost heating value with natural gas. Under these agreements, we are exposed to the spread between NGL prices and natural gas prices. The second type consists of percent of liquids agreements whereby we receive a portion of the extracted liquids with no direct exposure to the price of natural gas. Under these agreements, we are only exposed to NGL price movements. NGLs we retain in connection with these types of processing agreements are referred to as our equity NGL production. Our gathering and processing agreements have terms ranging from month-to-month to the life of the producing lease. Generally, our gathering and processing agreements are long-term agreements.

Our domestic gas gathering and processing customers are generally natural gas producers who have proved and/or producing natural gas fields in the areas surrounding our infrastructure. During 2008, these operations gathered and processed gas for approximately 230 gas gathering and processing customers. Our top six gathering and processing customers accounted for about 50 percent of our domestic gathering and processing revenue.

In addition to our natural gas assets, we own and operate three deepwater crude oil pipelines and a deepwater floating production platform in the Gulf of Mexico. Our crude oil transportation revenues are typically volumetric-based fee arrangements. However, a substantial portion of our marketing revenues are recognized from purchase and sale arrangements whereby we purchase oil from producers at the receipt points of our crude oil pipelines for an index-based price and sell the oil back to the producers at delivery points at the same index-based price. Our offshore floating production platform provides centralized services to deepwater producers such as compression, separation, production handling, water removal and pipeline landings. Revenue sources have historically included a combination of fixed-fee, volumetric-based fee and cost reimbursement arrangements. Fixed fees associated with the resident production at our Devils Tower facility are recognized on a units of production basis.

Geographically, our Midstream natural gas assets are positioned to maximize commercial and operational synergies with our other assets. For example, most of our offshore gathering and processing assets attach and process or condition natural gas supplies delivered to the Transco pipeline. Also, our gathering and processing facilities in the San Juan Basin handle about 87 percent of our Exploration & Production group s wellhead production in this basin. Both our San Juan Basin and Southwest Wyoming systems deliver residue gas volumes into Northwest Pipeline s interstate system in addition to third party interstate systems.

West Region domestic gathering, processing and treating

We own and/or operate domestic gas gathering, processing and treating assets within the western states of Wyoming, Colorado and New Mexico.

In the Rocky Mountain area, our assets include:

Approximately 3,500 miles of gathering pipelines serving the Wamsutter and southwest Wyoming areas in Wyoming;

Opal and Echo Springs processing plants with a combined daily inlet capacity of over 1,800 MMcf/d and NGL processing capacity of nearly 100 Mbbls/d.

In the Four Corners area, our assets include:

Approximately 3,800 miles of gathering pipelines serving the San Juan Basin in New Mexico and Colorado;

Ignacio, Kutz and Lybrook processing plants with a combined daily inlet capacity of 765 MMcf/d and NGL processing capacity of approximately 40 Mbbls/d;

Milagro and Esperanza natural gas treating plants, which remove carbon dioxide but do not extract NGLs, with a combined daily inlet capacity of 750 MMcf/d. At our Milagro facility, we also use the steam generated by gas-driven turbines to produce approximately 60 mega-watts per day of electricity which we primarily sell into the local electrical grid.

As we enter the Piceance Basin in Colorado, our initial infrastructure includes:

Parachute Lateral, a 38-mile, 30-inch diameter line transporting gas from the Parachute area to the Greasewood Hub and White River Hub in northwest Colorado. Our new Willow Creek processing plant (see expansion projects below) will process gas flowing through the Parachute Lateral in addition to processing gas from other sources. In an arrangement approved by the FERC, Midstream is leasing the pipeline to Gas Pipeline, who will continue to operate the Parachute Lateral until completion of a planned FERC abandonment filing;

PGX pipeline delivering NGLs previously transported by truck from Exploration & Production s existing Parachute area processing plants to a major NGL transportation pipeline system.

West region expansion projects

Our two major expansion projects include the new Willow Creek facility and additional capacity at our Echo Springs facility.

The Willow Creek processing plant is a 450 MMcf/d cryogenic natural gas processing plant in western Colorado s Piceance Basin, where Exploration & Production has its most significant volume of natural gas production, reserves and development activity. The plant is designed to recover 25 Mbbls/d of NGLs and the plant s inlet processing capacity is expected to be full at start-up expected in late 2009.

We expect to significantly increase the processing and NGL production capacities at our Echo Springs cryogenic natural gas processing plant in Wyoming. The addition of a fourth cryogenic processing train will add approximately 350 MMcf/d of processing capacity and 30 Mbbls/d of NGL production capacity, nearly doubling Echo Spring s capacities in both cases. We expect to begin construction on the fourth train at Echo Springs during the second half of 2009 and to bring the additional capacity online during late 2010, subject to all applicable permitting.

Gulf region domestic gathering, processing and treating

We own and/or operate domestic gas gathering and processing assets and crude oil pipelines primarily within the onshore and offshore shelf and deepwater areas in and around the Gulf Coast states of Texas, Louisiana, Mississippi and Alabama. We own:

Over 700 miles of onshore and offshore natural gas gathering pipelines, including:

The 115-mile deepwater Seahawk gas pipeline in the western Gulf of Mexico, flowing into our Markham processing plant and serving the Boomvang and Nansen field areas;

The 139-mile Canyon Chief gas pipeline, now including the new 37-mile Blind Faith extension, in the eastern Gulf of Mexico, flowing into our Mobile Bay processing plant and serving the Devils Tower, Triton, Goldfinger, Bass Lite and Blind Faith fields;

Mobile Bay, Markham, and Cameron Meadows processing plants with a combined daily inlet capacity of nearly 1,500 MMcf/d and NGL handling capacity of 65 Mbbls/d;

Canyon Station offshore gas production system fixed-leg platform, which brings natural gas to specifications allowable by major interstate pipelines but does not extract NGLs, with a daily inlet capacity of 500 MMcf/d;

Three deepwater crude oil pipelines with a combined length of 300 miles and capacity of 300 Mbbls/d including:

BANJO pipeline running parallel to the Seahawk gas pipeline delivering production from two producer-owned spar-type floating production systems; and delivering production to our shallow-water platform at Galveston Area Block A244 (GA-A244) and then onshore through ExxonMobil s Hoover Offshore Oil Pipeline System (HOOPS);

Alpine pipeline in the central Gulf of Mexico, serving the Gunnison field, and delivering production to GA-A244 and then onshore through HOOPS under a joint tariff agreement;

Mountaineer oil pipeline which connects to similar production sources as our Canyon Chief pipeline and, now including the new Blind Faith extension, ultimately delivering production to ChevronTexaco s Empire Terminal in Plaquemines Parish, Louisiana;

Devils Tower floating production platform located in Mississippi Canyon Block 773, approximately 150 miles south-southwest of Mobile, Alabama and serving production from the Devils Tower, Triton, Goldfinger and Bass Lite fields. Located in 5,610 feet of water, it is one of the world s deepest dry tree spars. The platform, which is operated by ENI Petroleum on our behalf, is capable of handling 210 MMcf/d of natural gas and 60 Mbbls/d of oil.

Gulf region expansion projects

The deepwater Gulf continues to be an attractive growth area for our Midstream business. Since 1997, we have invested over $1.5 billion in new midstream assets in the Gulf of Mexico. These facilities provide both onshore and offshore services through pipelines, platforms and processing plants. The new facilities could also attract incremental gas volumes to Transco s pipeline system in the southeastern United States.

Our current major expansion projects in the Gulf region include:

In the deepwater of the Gulf of Mexico, we completed construction of 37-mile extensions of both of our oil and gas pipelines from our Devils Tower spar to the Blind Faith discovery located in Mississippi Canyon in the eastern deepwater of the Gulf of Mexico. The pipelines have been commissioned and production began flowing in the fourth quarter of 2008;

In the western deepwater of the Gulf of Mexico, we continued construction activities on our Perdido Norte project which will include an expansion of our onshore Markham gas processing facility and oil and gas lines that would expand the scale of our existing infrastructure.

Venezuela

Our Venezuelan investments involve gas compression and an equity interest in a gas processing and NGL fractionation operation. We own controlling interests and operate three gas compressor facilities which provide roughly 65 percent of the gas injections in eastern Venezuela. These facilities help stabilize the reservoir and enhance the recovery of crude oil by re-injecting natural gas at high pressures. The three gas compressor facilities, owned within two of our Venezuelan subsidiaries, had a net book value of $324 million at December 31, 2008 and are held as security on $177 million of non-recourse debt at December 31, 2008. We own controlling interests of 70% and 66.67% in these two subsidiaries.

Our Venezuelan assets were constructed and are currently operated for the exclusive benefit of the Venezuelan state-owned oil company, Petróleos de Venezuela S.A. under long-term contracts. These significant contracts have a remaining term between 9 and 12 years and our revenues are based on a combination of fixed capital payments, throughput volumes and, in the case of one of the gas compression facilities, a minimum throughput guarantee. The Venezuelan government continues its public criticism of U.S. economic and political policy, has implemented unilateral changes to existing energy related contracts, and has expropriated privately held assets within the energy and telecommunications sector. The continued threat of nationalization of certain energy-related assets in Venezuela could have a material negative impact on our results of operations. The economic situation resulting from lower commodity prices could jeopardize the Venezuelan oil industry and may further exacerbate political tension in Venezuela. We may not receive adequate compensation, or any compensation, if our assets in Venezuela are nationalized.

We also own a 49.25 percent interest in Accroven SRL which includes two 400 MMcf/d NGL extraction plants, a 50 Mbbls/d NGL fractionation plant and associated storage and refrigeration facilities. Our equity investment had a book value of $69 million at December 31, 2008.

Olefins

In the Gulf of Mexico region, we own a 10/12 interest in and are the operator of an ethane cracker at Geismar, Louisiana, with a total production capacity of 1.3 billion pounds of ethylene and 90 million pounds of propylene per year. Our feedstock for the ethane cracker is ethane and propane; as a result, we are exposed to the price spread between ethane and propane, and ethylene and propylene. We also own ethane and propane pipeline systems and a refinery grade propylene splitter with a production capacity of approximately 500 million pounds per year of propylene and its related pipeline system in Louisiana. At our propylene splitter, we purchase refinery grade propylene and fractionate it into polymer grade propylene and propane; as a result we are exposed to the price spread between those commodities.

Our Canadian operations include an olefin liquids extraction plant located near Ft. McMurray, Alberta and an olefin fractionation facility near Edmonton, Alberta. Our facilities extract olefinic liquids from the off-gas produced by a third party oil sands bitumen upgrading process. Our arrangement with the third-party upgrade is a keep whole type where we remove a mix of NGLs and olefins from the off-gas and return the equivalent heating value back to the third party in the form of natural gas. We then fractionate, treat, store, terminal and sell the propane, propylene, butane, butylenes and condensate recovered from this process. Our commodity price exposure is the spread between the price for natural gas and the NGL and olefin products we produce. We continue to be the only olefins fractionator in western Canada and the only treater/processor of oil sands upgrader off-gas. These operations extract petrochemical feedstocks from upgrader off-gas streams allowing the upgraders to burn cleaner natural gas streams and reduce overall air emissions. The extraction plant has processing capacity in excess of 100 MMcf/d with the ability to recover in excess of 15 Mbbls/d of olefin and NGL products.

NGL and olefin marketing services

In addition to our gathering, processing and olefin production operations, we market NGLs and olefin products to a wide range of users in the energy and petrochemical industries. The NGL marketing business transports and markets equity NGLs from the production at our domestic processing plants, and also markets NGLs on behalf of third-party NGL producers, including some of our fee-based processing customers, and the NGL volumes owned by Discovery Producer Services L.L.C. The NGL marketing business bears the risk of price changes in these NGL volumes while they are being transported to final sales delivery points. In order to meet sales contract obligations, we may purchase products in the spot market for resale. The majority of domestic sales are based on supply contracts of one year or less in duration. The production from our Canadian facilities is marketed in Canada and in the United States.

Other

We own interests in and/or operate NGL fractionation and storage assets. These assets include two partially owned NGL fractionation facilities: one near Conway, Kansas and the other in Baton Rouge, Louisiana that have a combined capacity in excess of 167 Mbbls/d. We also own approximately 20 million barrels of NGL storage capacity in central Kansas near Conway.

We own an equity interest in and operate the facilities of Discovery Producer Services LLC and its subsidiary Discovery Gas Transmission Services LLC (collectively, Discovery) through our interest in WPZ. Discovery s assets include a 600 MMcf/d cryogenic natural gas processing plant near Larose, Louisiana, a 32 Mbbl/NGL fractionator plant near Paradis, Louisiana and an offshore natural gas gathering and transportation system in the Gulf of Mexico.

We also own a 14.6 percent equity interest in Aux Sable Liquid Products and its Channahon, Illinois gas processing and NGL fractionation facility near Chicago. The facility is capable of processing up to 2.1 Bcf/d of natural gas from the Alliance Pipeline system and fractionating approximately 87 Mbbls/d of extracted liquids into NGL products.

Operating statistics

The following table summarizes our significant operating statistics for Midstream:

	2008	**2007**	**2006**
Volumes(1):			
Domestic gathering (TBtu)	1,013	1,045	1,181
Plant inlet natural gas (TBtu)	1,311	1,275	1,222

Domestic NGL production (Mbbls/d)(2)	154	163	152
Domestic NGL equity sales (Mbbls/d)(2)	80	92	88
Crude oil gathering (Mbbls/d)(2)	70	80	86
Canadian NGL equity sales (Mbbls/d)(2)	7	9	8
Olefin (ethylene and propylene) sales (millions of pounds)	1,605	1,401	988

(1) Excludes volumes associated with partially owned assets that are not consolidated for financial reporting purposes.

(2) Annual Average Mbbls/d.

Table of Contents

WPZ

WPZ was formed in 2005 to engage in gathering, transporting, processing and treating natural gas and fractionating and storing NGLs. We currently own approximately a 23.6 percent limited partnership interest including the interests of the general partner, Williams Partners GP LLC, which is wholly owned by us, and incentive distribution rights. WPZ provides us with an alternative source of equity capital. WPZ also creates a vehicle to monetize our qualifying assets. Such transactions, which are subject to approval by the boards of directors of both Williams and WPZ s general partner, allow us to retain control of the assets through our ownership interest in WPZ and operation of the assets. WPZ s asset portfolio includes Williams Four Corners LLC, certain ownership interests in Wamsutter LLC, a 60 percent interest in Discovery, three integrated NGL storage facilities near Conway, Kansas, a 50 percent interest in an NGL fractionator near Conway, Kansas and the Carbonate Trend sour gas gathering pipeline off the coast of Alabama.

Gas Marketing Services

Gas Marketing Services (Gas Marketing) primarily supports our natural gas businesses by providing marketing and risk management services, which includes marketing and hedging the gas produced by Exploration & Production, and procuring fuel and shrink gas and hedging natural gas liquids sales for Midstream. Gas Marketing also provides similar services to third parties, such as producers. In addition, Gas Marketing manages various natural gas-related contracts such as transportation, storage, related hedges and proprietary trading positions, including certain legacy natural gas contracts and positions.

Gas Marketing s 2008 natural gas purchase volumes include 1.4Bcf/d of gas produced by Exploration & Production and another 1.0 Bcf/d from third party/other sources. This natural gas was in turn marketed and sold to third parties (2.0 Bcf/d) and to Midstream (.4 Bcf/d).

Our Exploration & Production and Midstream segments may execute commodity hedges with Gas Marketing. In turn, Gas Marketing may execute offsetting derivative contracts with unrelated third parties.

As a result of the sale of a substantial portion of our Power business in the fourth quarter of 2007, Gas Marketing is also responsible for certain remaining legacy natural gas contracts and positions. During 2008, we substantially reduced the overall legacy positions remaining.

Additional Business Segment Information

Our ongoing business segments are accounted for as continuing operations in the accompanying financial statements and notes to financial statements included in Part II.

Operations related to certain assets in Discontinued Operations have been reclassified from their traditional business segment to Discontinued Operations in the accompanying financial statements and notes to financial statements included in Part II.

We perform certain management, legal, financial, tax, consultation, information technology, administrative and other services for our subsidiaries.

Our principal sources of cash are from dividends and advances from our subsidiaries, investments, payments by subsidiaries for services rendered, interest payments from subsidiaries on cash advances and, if needed, external financings, sales of master limited partnership units to the public, and net proceeds from asset sales. The amount of dividends available to us from subsidiaries largely depends upon each subsidiary s earnings and operating capital requirements. The terms of certain of our subsidiaries borrowing arrangements limit the transfer of funds to us.

We believe that we have adequate sources and availability of raw materials and commodities for existing and anticipated business needs. In support of our energy commodity activities, primarily conducted through Gas Marketing Services, our counterparties require us to provide various forms of credit support such as margin, adequate assurance amounts and pre-payments for gas supplies. Our pipeline systems are all regulated in various ways resulting in the financial return on the investments made in the systems being limited to standards permitted by the regulatory agencies. Each of the pipeline systems has ongoing capital requirements for efficiency and mandatory improvements, with expansion opportunities also necessitating periodic capital outlays.

REGULATORY MATTERS

Exploration & Production. Our Exploration & Production business is subject to various federal, state and local laws and regulations on taxation and payment of royalties, and the development, production and marketing of oil and gas, and environmental and safety matters. Many laws and regulations require drilling permits and govern the spacing of wells, rates of production, water discharge, prevention of waste and other matters. Such laws and regulations have increased the costs of planning, designing, drilling, installing, operating and abandoning our oil and gas wells and other facilities. In addition, these laws and regulations, and any others that are passed by the jurisdictions where we have production, could limit the total number of wells drilled or the allowable production from successful wells, which could limit our reserves.

Gas Pipeline. Gas Pipeline s interstate transmission and storage activities are subject to FERC regulation under the Natural Gas Act of 1938 (NGA) and under the Natural Gas Policy Act of 1978, and, as such, its rates and charges for the transportation of natural gas in interstate commerce, its accounting, and the extension, enlargement or abandonment of its jurisdictional facilities, among other things, are subject to regulation. Each gas pipeline company holds certificates of public convenience and necessity issued by the FERC authorizing ownership and operation of all pipelines, facilities and properties for which certificates are required under the NGA. Each gas pipeline company is also subject to the Natural Gas Pipeline Safety Act of 1968, as amended, and the Pipeline Safety Improvement Act of 2002, which regulates safety requirements in the design, construction, operation and maintenance of interstate natural gas transmission facilities. FERC Standards of Conduct govern how our interstate pipelines communicate and do business with gas marketing employees. Among other things, the Standards of Conduct require that interstate pipelines not operate their systems to preferentially benefit gas marketing functions.

Each of our interstate natural gas pipeline companies establishes its rates primarily through the FERC s ratemaking process. Key determinants in the ratemaking process are:

- Costs of providing service, including depreciation expense;
- Allowed rate of return, including the equity component of the capital structure and related income taxes; and
- Volume throughput assumptions.

The allowed rate of return is determined in each rate case. Rate design and the allocation of costs between the demand and commodity rates also impact profitability. As a result of these proceedings, certain revenues previously collected may be subject to refund.

Midstream Gas & Liquids. For our Midstream segment, onshore gathering is subject to regulation by states in which we operate and offshore gathering is subject to the Outer Continental Shelf Lands Act (OCSLA). Of the states where Midstream gathers gas, currently only Texas actively regulates gathering activities. Texas regulates gathering primarily through complaint mechanisms under which the state commission may resolve disputes involving an individual gathering arrangement. Although offshore gathering facilities are not subject to the NGA, offshore transmission pipelines are subject to the NGA, and in recent years the FERC has taken a broad view of offshore transmission, finding many shallow-water pipelines to be jurisdictional transmission. Most gathering facilities offshore are subject to the OCSLA, which provides in part that outer continental shelf pipelines must provide open and nondiscriminatory access to both owner and non-owner shippers.

Midstream also owns interests in and operates two offshore transmission pipelines that are regulated by the FERC because they are deemed to transport gas in interstate commerce. Black Marlin Pipeline Company provides transportation service for offshore Texas production in the High Island area and redelivers that gas to intrastate pipeline interconnects near Texas City. Discovery provides transportation service for offshore Louisiana production from the South Timbalier, Grand Isle, Ewing Bank and Green Canyon (deepwater) areas to an onshore processing facility and downstream interconnect points with major interstate pipelines. FERC regulation requires all terms and conditions of service, including the rates charged, to be filed with and approved by the FERC before any changes can go into effect. In 2007, Black Marlin filed and settled a major rate change application before the FERC, resulting in increased rates for service. In November 2007, Discovery filed a settlement in lieu of a rate change filing, which the FERC approved effective January 1, 2008, for all parties, except one protestor, Exxon Mobil Gas

Table of Contents

and Power Marketing Company. Among other things, the settlement increases Discovery s rates for service, although most volumes flowing before the settlement became effective are not affected by the rate change due to life of lease rates and commitments.

Our Midstream Canadian assets are regulated by the Energy Resources Conservation Board (ERCB) and Alberta Environment. The regulatory system for the Alberta oil and gas industry incorporates a large measure of self-regulation, providing that licensed operators are held responsible for ensuring that their operations are conducted in accordance with all provincial regulatory requirements. For situations in which non-compliance with the applicable regulations is at issue, the ERCB and Alberta Environment have implemented an enforcement process with escalating consequences.

Gas Marketing Services. Our Gas Marketing business is subject to a variety of laws and regulations at the local, state and federal levels, including the FERC and the Commodity Futures Trading Commission regulations. In addition, natural gas markets continue to be subject to numerous and wide-ranging federal and state regulatory proceedings and investigations. We are also subject to various federal and state actions and investigations regarding, among other things, market structure, behavior of market participants, market prices, and reporting to trade publications. We may be liable for refunds and other damages and penalties as a result of ongoing actions and investigations. The outcome of these matters could affect our creditworthiness and ability to perform contractual obligations as well as other market participants creditworthiness and ability to perform contractual obligations to us.

See Note 16 of our Notes to Consolidated Financial Statements for further details on our regulatory matters.

ENVIRONMENTAL MATTERS

Our generation facilities, processing facilities, natural gas pipelines, and exploration and production operations are subject to federal environmental laws and regulations as well as the state and tribal laws and regulations adopted by the jurisdictions in which we operate. We could incur liability to governments or third parties for any unlawful discharge of oil, gas or other pollutants into the air, soil, or water, as well as liability for clean up costs. Materials could be released into the environment in several ways including, but not limited to:

- From a well or drilling equipment at a drill site;
- Leakage from gathering systems, pipelines, processing or treating facilities, transportation facilities and storage tanks;
- Damage to oil and gas wells resulting from accidents during normal operations; and
- Blowouts, cratering and explosions.

Because the requirements imposed by environmental laws and regulations are frequently changed, we cannot assure you that laws and regulations enacted in the future, including changes to existing laws and regulations, will not adversely affect our business. In addition, we may be liable for environmental damage caused by former operators of our properties.

We believe compliance with environmental laws and regulations will not have a material adverse effect on capital expenditures, earnings or competitive position. However, environmental laws and regulations could affect our business in various ways from time to time, including incurring capital and maintenance expenditures, fines and penalties, and creating the need to seek relief from the FERC for rate increases to recover the costs of certain capital expenditures and operation and maintenance expenses.

For a discussion of specific environmental issues, see Environmental under Management s Discussion and Analysis of Financial Condition and Results of Operations and Environmental Matters in Note 16 of our Notes to Consolidated Financial Statements.

COMPETITION

Exploration & Production. Our Exploration & Production segment competes with other oil and gas concerns, including major and independent oil and gas companies in the development, production and marketing of natural gas. We compete in areas such as acquisition of oil and gas properties and obtaining necessary equipment, supplies and services. We also compete in recruiting and retaining skilled employees.

Gas Pipeline. The natural gas industry has undergone significant change over the past two decades. A highly-liquid competitive commodity market in natural gas and increasingly competitive markets for natural gas services, including competitive secondary markets in pipeline capacity, have developed. As a result, pipeline capacity is being used more efficiently, and peaking and storage services are increasingly effective substitutes for annual pipeline capacity.

Local distribution company (LDC) and electric industry restructuring by states have affected pipeline markets. Pipeline operators are increasingly challenged to accommodate the flexibility demanded by customers and allowed under tariffs, but the changes implemented at the state level have not required renegotiation of LDC contracts. The state plans have in some cases discouraged LDCs from signing long-term contracts for new capacity.

States are in the process of developing new energy plans that may require utilities to encourage energy saving measures and diversify their energy supplies to include renewable sources. This could lower the growth of gas demand.

These factors have increased the risk that customers will reduce their contractual commitments for pipeline capacity. Future utilization of pipeline capacity will also depend on competition from LNG imported into markets and new pipelines from the Rockies and other new producing areas, many of which are utilizing master limited partnership structures with a lower cost of capital, and on growth of natural gas demand.

Midstream Gas & Liquids. In our Midstream segment, we face regional competition with varying competitive factors in each basin. Our gathering and processing business competes with other midstream companies, interstate and intrastate pipelines, producers and independent gatherers and processors. We primarily compete with five to ten companies across all basins in which we provide services. Numerous factors impact any given customer s choice of a gathering or processing services provider, including rate, location, term, timeliness of services to be provided, pressure obligations and contract structure. We also compete in recruiting and retaining skilled employees. In 2005, we formed WPZ to help compete against other master limited partnerships for midstream projects. By virtue of the master limited partnership structure, WPZ provides us with an alternative source of equity capital.

Gas Marketing Services. In our Gas Marketing Services segment, we compete directly with large independent energy marketers, marketing affiliates of regulated pipelines and utilities, and natural gas producers. We also compete with brokerage houses, energy hedge funds and other energy-based companies offering similar services.

EMPLOYEES

At February 1, 2009, we had approximately 4,704 full-time employees including 924 at the corporate level, 798 at Exploration & Production, 1,726 at Gas Pipeline, 1,232 at Midstream Gas & Liquids, and 24 at Gas Marketing Services. None of our employees are represented by unions or covered by collective bargaining agreements.

FINANCIAL INFORMATION ABOUT GEOGRAPHIC AREAS

See Note 18 of our Notes to Consolidated Financial Statements for amounts of revenues during the last three fiscal years from external customers attributable to the United States and all foreign countries. Also see Note 18 of our Notes to Consolidated Financial Statements for information relating to long-lived assets during the last three fiscal years, located in the United States and all foreign countries.

Item 1A. *Risk Factors*

FORWARD-LOOKING STATEMENTS/RISK FACTORS AND CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain matters contained in this report include forward-looking statements within the meaning of section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements discuss our expected future results based on current and pending business operations. We make these forward-looking statements in reliance on the safe harbor protections provided under the Private Securities Litigation Reform Act of 1995.

All statements, other than statements of historical facts, included in this report that address activities, events or developments that we expect, believe or anticipate will exist or may occur in the future, are forward-looking statements. Forward-looking statements can be identified by various forms of words such as anticipates, believes, could, may, should, continues, estimates, expects, forecasts, might, planned, potential, projects, expressions. These forward-looking statements include, among others, statements regarding:

- Amounts and nature of future capital expenditures;
- Expansion and growth of our business and operations;
- Financial condition and liquidity;
- Business strategy;
- Estimates of proved gas and oil reserves;
- Reserve potential;
- Development drilling potential;
- Cash flow from operations or results of operations;
- Seasonality of certain business segments;
- Natural gas and NGL prices and demand.

Forward-looking statements are based on numerous assumptions, uncertainties and risks that could cause future events or results to be materially different from those stated or implied in this report. Many of the factors that will determine these results are beyond our ability to control or project. Specific factors which could cause actual results to differ from those in the forward-looking statements include:

- Availability of supplies (including the uncertainties inherent in assessing, estimating, acquiring and developing future natural gas reserves), market demand, volatility of prices, and the availability and costs of capital;
- Inflation, interest rates, fluctuation in foreign exchange, and general economic conditions (including the recent economic slowdown and the disruption of global credit markets and the impact of these events on our

customers and suppliers);

The strength and financial resources of our competitors;

Development of alternative energy sources;

The impact of operational and development hazards;

Costs of, changes in, or the results of laws, government regulations (including proposed climate change legislation), environmental liabilities, litigation, and rate proceedings;

Our costs and funding obligations for defined benefit pension plans and other postretirement benefit plans;

Changes in the current geopolitical situation;

Risks related to strategy and financing, including restrictions stemming from our debt agreements, future changes in our credit ratings and the availability and cost of credit;

Risks associated with future weather conditions;

Acts of terrorism and

Additional risks described in our filings with the SEC.

Given the uncertainties and risk factors that could cause our actual results to differ materially from those contained in any forward-looking statement, we caution investors not to unduly rely on our forward-looking statements. We disclaim any obligations to and do not intend to update the above list or to announce publicly the result of any revisions to any of the forward-looking statements to reflect future events or developments.

In addition to causing our actual results to differ, the factors listed above and referred to below may cause our intentions to change from those statements of intention set forth in this report. Such changes in our intentions may also cause our results to differ. We may change our intentions, at any time and without notice, based upon changes in such factors, our assumptions or otherwise.

Because forward-looking statements involve risks and uncertain/DT>
difficulty in collecting accounts receivable and longer collection periods;

costs of enforcing contractual obligations in foreign jurisdictions;

recessions in economies outside of the United States;

political instability and unexpected changes in diplomatic and trade relationships;

currency exchange rate fluctuations; and

potentially adverse tax consequences.

If we are successful in introducing our products into foreign markets, we will be affected by these additional business risks, which may adversely impact our financial condition or results of operations. In addition, expansion into foreign markets imposes additional burdens on our executive and administrative personnel, research and sales departments, and general managerial resources. Our efforts to introduce our products into foreign markets may not be successful, in which case we may have expended significant resources without realizing the expected benefit. Ultimately, the investment required for expansion into foreign markets could exceed the revenues generated from this expansion.

Our operating results may fluctuate due to various factors and, as a result, period-to-period comparisons of our results of operations will not necessarily be meaningful.

Factors relating to our business make our future operating results uncertain and may cause them to fluctuate from period to period. These factors include:

changes in the availability of third-party reimbursement in the United States or other countries;

the timing of new product announcements and introductions by us or our competitors;

market acceptance of new or enhanced versions of our products;

changes in manufacturing costs or other expenses;

competitive pricing pressures;

the gain or loss of significant distribution outlets or customers;

increased research and development expenses;

the timing of any future acquisitions; or

general economic conditions.

Because our operating results may fluctuate from quarter to quarter, it may be difficult for us or our investors to predict our future performance by viewing our historical operating results.

Anti-takeover provisions in our organizational documents and Delaware law, and those anti-takeover provisions adopted by the Company in 2007, may discourage or prevent a change of control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our certificate of incorporation and bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors that our stockholders might consider favorable. Some of these provisions:

- authorize the issuance of preferred stock which can be created and issued by the board of directors without prior stockholder approval, with rights senior to those of our common stock;
- provide for a classified board of directors, with each director serving a staggered three-year term;
- prohibit our stockholders from filling board vacancies, calling special stockholder meetings, or taking action by written consent;
- provide for the removal of a director only with cause and by the affirmative vote of the holders of 75% or more of the shares then entitled to vote at an election of our directors; and
- require advance written notice of stockholder proposals and director nominations.

We have adopted a Shareholder Rights Plan that could make it more difficult for a third party to acquire, or could discourage a third party from acquiring, the Company or a large block of our common stock. A third party that acquires 15% or more of our common stock (an "acquiring person") could suffer substantial dilution of its ownership interest under the terms of the Shareholder Rights Plan through the issuance of common stock to all shareholders other than the acquiring person.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our certificate of incorporation, bylaws and Delaware law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by our then-current board of directors, including a merger, tender offer, or proxy contest involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could cause the market price of our common stock to decline.

We do not intend to pay cash dividends.

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. In addition, the terms of any future debt or credit facility may preclude us from paying any dividends. As a result, capital appreciation, if any, of our common stock will be our stockholders sole source of potential gain for the foreseeable future.

ITEM 1B. UNRESOLVED STAFF COMMENTS

We have not received written comments from the Securities and Exchange Commission regarding our periodic or current reports under the Securities and Exchange Act of 1934, as amended, 180 days or more before December 31, 2007 that remain unresolved.

ITEM 2. PROPERTIES

Our headquarters is located in a 30,000 square foot facility in Waltham, Massachusetts, which we occupy under an office lease expiring in March 2013. We also operate in a 13,700 square foot facility in Columbia, Maryland, leased to us until October 31, 2009. We believe that our existing facilities are adequate for our current needs.

ITEM 3. LEGAL PROCEEDINGS

In the second quarter of 2006, we received a subpoena from the Office of Inspector General, or OIG, of the Department of Health and Human Services requesting documents from us in connection with an investigation of potential violations of the federal anti-kickback statute and False Claims Act. In addition, on June 21, 2007, we received a subpoena from the U.S. Attorney's Office for the District of Massachusetts requesting documents from us in connection with an investigation by the DOJ. We understand that the DOJ is investigating various aspects of our practices relating to the NC-stat System, including sales and marketing practices. We are cooperating with both investigations. During 2007, we formed a Special Committee of our Board of Directors to provide oversight of an ongoing independent review of our sales and marketing practices and of our continuing cooperation with the DOJ and OIG investigations. We cannot predict the ultimate outcome of these investigations. We are unable to determine when these matters will be resolved, whether any additional areas of inquiry will be opened, or any outcome of this matter. Any negative findings in this matter could result in fines, penalties, or program exclusions, which could have a material adverse effect on our financial condition, results of operations, and cash flows.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter of the year ended December 31, 2007, through the solicitation of proxies or otherwise.

PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is quoted on the NASDAQ Global Market under the symbol "NURO". The price range per share reflected in the table below is the high and low closing sales prices of our common stock as reported by NASDAQ for the periods indicated.

	Years ended December 31,			
	2007		2006	
	High	Low	High	Low
First quarter	$ 14.50	$ 9.25	$ 39.19	$ 28.00
Second quarter	$ 10.76	$ 8.62	$ 40.39	$ 25.73
Third quarter	$ 9.12	$ 7.25	$ 33.18	$ 18.74
Fourth quarter	$ 10.25	$ 7.79	$ 19.85	$ 13.52

On March 7, 2008, there were approximately 136 stockholders of record of our common stock. This number does not include stockholders for whom shares were held in a "nominee" or "street" name. On March 7, 2008, the last reported sale price per share of our common stock on the NASDAQ Global Market was $2.03.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain future earnings, if any, to finance the expansion and growth of our business and do not expect to pay any cash dividends in the foreseeable future. Payment of future cash dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs and plans for expansion.

See Part III, Item 12 for information regarding securities authorized for issuance under equity compensation plans.

COMPARATIVE STOCK PERFORMANCE GRAPH

The following graph shows the cumulative stockholder return of our common stock from July 22, 2004 (the first trading day for our common stock) through December 31, 2007 as compared with that of the Nasdaq (U.S. Companies) Index and the Nasdaq Medical Device Manufacturers Index. The total stockholder return is measured by dividing the per share price change of the respective securities, plus dividends, if any, for each period shown by the share price at the end of the particular period. The graph assumes the investment of $100 in our common stock and each of the comparison groups on July 22, 2004 and assumes the reinvestment of dividends. We have never declared a dividend on our common stock. The stock price performance depicted in the graph below is not necessarily indicative of future price performance.

	07/22/04	12/31/04	12/31/05	12/31/06	12/31/07
NeuroMetrix, Inc.	$ 100.00	$ 146.88	$ 341.00	$ 186.38	$ 115.00
Nasdaq Stock Market (U.S.)	$ 100.00	$ 115.25	$ 117.69	$ 129.32	$ 140.24
Nasdaq Medical Device Manuf. Index	$ 100.00	$ 112.49	$ 123.50	$ 130.24	$ 165.52

ITEM 6: SELECTED FINANCIAL DATA

The data set forth below should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" and our financial statements and related notes appearing elsewhere in this Annual Report on Form 10-K.

	Years Ended December 31,				
	2007	2006	2005	2004	2003
	(In thousands, except share and per share data)				
Statement of Operations Data:					
Revenues	$ 44,622	$ 55,250	$ 34,298	$ 17,920	$ 9,168
Cost of revenues	12,062	13,558	8,858	4,853	2,707
Gross margin	32,560	41,692	25,440	13,067	6,461
Operating expenses:					
Research and development	4,892	5,011	3,821	3,268	2,397
Sales and marketing	22,964	22,014	14,150	8,488	4,768
General and administrative	14,834	11,805	8,022	5,267	3,052
Total operating expenses	42,690	38,829	25,993	17,024	10,217
Income (loss) from operations	(10,129)	2,862	(553)	(3,957)	(3,756)
Interest income (expense), net	1,751	1,598	837	(750)	(113)
Income (loss) before provision for income taxes	(8,378)	4,461	284	(4,707)	(3,869)
Provision for income taxes		193	35		
Net income (loss)	(8,378)	4,268	249	(4,707)	(3,869)
Accretion of dividend on redeemable convertible preferred stock				(1,386)	(2,009)
Deemed dividend on redeemable convertible preferred stock				(788)	
Beneficial conversion feature associated with redeemable convertible preferred stock				(7,051)	
Net income (loss) attributable to common stockholders	$ (8,378)	$ 4,268	$ 249	$ (13,932)	$ (5,878)
Net income (loss) per common share:					
Basic	$ (0.66)	$ 0.34	$ 0.02	$ (2.42)	$ (5.66)
Diluted	$ (0.66)	$ 0.33	$ 0.02	$ (2.42)	$ (5.66)
Weighted average common shares outstanding:					
Basic	12,628,310	12,501,742	12,152,139	5,747,579	1,038,817
Diluted	12,628,310	13,097,891	12,986,365	5,747,579	1,038,817

	As of December 31,				
	2007	2006	2005	2004	2003
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 7,097	$ 7,910	$ 8,170	$ 1,936	$ 1,623
Short-term investments	22,622	32,411	24,082	18,575	
Working capital	33,304	41,894	33,268	21,774	2,451
Long-term investments	1,058			9,497	
Total assets	56,375	55,706	42,897	37,953	7,218
Long-term debt and other long-term liabilities	33	73	131	189	2,232
Warrants for redeemable convertible preferred stock					450
Redeemable convertible preferred stock					47,694
Accumulated deficit	(62,066)	(53,687)	(57,955)	(58,204)	(45,204)
Total stockholders' equity(deficit)	46,730	43,409	34,833	33,330	(45,805)

51

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our financial condition and results of operations in conjunction with our selected financial data, our condensed financial statements and the accompanying notes to those financial statements included elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. As a result of many factors, such as those set forth under the section titled "Risk Factors" and elsewhere in this Annual Report on Form 10-K, our actual results may differ materially from those anticipated in these forward-looking statements.

Overview

NeuroMetrix was founded in June 1996. We design, develop and market proprietary medical devices used to help physicians diagnose and treat diseases of the nervous system such as neuropathies, which are disorders of the peripheral nerves and parts of the spine, and neurovascular disorders such as diabetic retinopathy. We are also developing medical devices designed to be used to provide regional anesthesia and pain control. To date, our focus has been on products that help physicians with the diagnosis of neuropathies and neurovascular disorders. We have two products lines cleared by the United States Food and Drug Administration, or FDA, that are currently being marketed to physicians and clinics, including the NC-stat System for the assessment of neuropathies and the DigiScope for the detection of eye disorders such as diabetic retinopathy.

We believe that our neuropathy diagnostic system, the NC-stat System, improves the quality and efficiency of patient care by offering all physicians the ability to diagnose patients with neuropathies at the point-of-service, that is, in the physician's office at the time the patient is examined, resulting in earlier and more accurate detection, greater patient comfort and convenience, and, in many cases, improved clinical and economic outcomes. The NC-stat System is comprised of: (1) disposable single use NC-stat biosensors that are placed on the patient's body, (2) the NC-stat monitor and related components and (3) the NC-stat docking station, an optional device that enables the physician's office to transmit data to our onCall Information System. The NC-stat System has been on the market since May 1999 and is used in over 5,500 physician's offices and clinics in the United States. Over 1.0 million patients have had nerve conduction tests performed using the NC-stat System. Substantially all of our revenues to date have been derived from sales of the NC-stat System. We are currently developing a traditional nerve conduction system, the ADVANCE System, for the diagnosis of neuropathies and have filed a 510(k) application with the FDA. Presuming it is successfully commercialized, the ADVANCE System is expected to provide physicians with even greater clinical functionality and is expected to be marketed to specialists such as neurologists as well as primary care physicians.

Acquisition

On December 26, 2007, we acquired substantially all of the assets and assumed certain liabilities of EyeTel Imaging, Inc., or EyeTel, and their product, the DigiScope, a product used for the detection of eye disorders such as diabetic retinopathy, for 1,050,297 shares of common stock, $175,000 in cash and the assumption of certain liabilities.

Neurovascular disease includes conditions such as retinopathy, an eye disease prevalent in patients with diabetes. The DigiScope is marketed to the primary diabetes care physician office market and the optometry market. Prior to the acquisition of substantially all of the assets and the assumption of certain liabilities of EyeTel, we had been marketing the DigiScope to the primary diabetes care physician office market through an exclusive sales and marketing license with EyeTel. The DigiScope allows physicians to diagnose diabetic retinopathy and refer patients to an eye specialist for treatment if deemed necessary based on the results. It is recommended by the American Diabetes Association, or

ADA, that all patients with diabetes receive an annual dilated eye examination to monitor vision. According to the ADA, there are approximately 21.0 million people in the United States with diabetes and only approximately 50% comply with the recommendation to have an annual eye examination. We believe that a product such as the DigiScope in primary diabetes care physician offices and optometry clinics could potentially lead to an increase in the level of testing and result in the earlier detection of eye diseases in patients with diabetes and improved clinical outcomes.

Corporate Collaborations

In November 2007, we made an investment of $2.5 million for the purchase of approximately 5.4 million shares of common stock of Cyberkinetics Neurotechnology Systems, Inc., or Cyberkinetics, representing approximately 13% of the Cyberkinetics' issued and outstanding shares at the time of the investment, at a price of $0.46 per share. We also received a warrant to purchase up to approximately 2.7 million shares of Cyberkinetics common stock. The warrant, exercisable at $0.46 per share, has a term of five years, and is required to be exercised if Cyberkinetics receives FDA approval of a Humanitarian Device Exemption, or HDE, filing for the Andara Oscillating Field Stimulator , or Andara OFS, device for acute spinal cord injuries. In addition, we received a seat on the Cyberkinetics Board of Directors. Dr. Shai Gozani M.D. Ph.D., our Chief Executive Officer and President, has been named as our initial designee.

In connection with the investment in Cyberkinetics, we also received certain rights, including a right of first negotiation for the acquisition of Cyberkinetics and a right of first negotiation for the commercialization of the Andara OFS device for the treatment of acute spinal cord injuries.

In February 2008, we entered into a Collaboration Agreement and Operating Agreement with Cyberkinetics to develop and commercialize products for the treatment of peripheral nerve injury and formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture with 50% ownership held by us and 50% ownership held by Cyberkinetics.

We derive the majority of our revenues from the sale of NC-stat biosensors, monitors and docking stations directly to end users, which are generally physician practice groups. Our NC-stat biosensors are disposable products that are used once and inactivated after use. The NC-stat monitor is an electronic instrument that is used with the NC-stat biosensors to perform nerve conduction studies for the purpose of diagnosing neuropathies. The NC-stat monitor displays the results of nerve conduction studies on a LCD screen immediately at the conclusion of each study. The NC-stat docking station is an optional device that is used to transmit to the onCall Information System data generated by the nerve conduction study performed with the NC-stat monitor. The onCall Information System automatically formulates the data it receives for each test into a detailed report that is provided to the customer through facsimile or e-mail.

We also derive revenues from sales of the DigiScope to physicians through (1) eye scan fees, (2) monthly rental fees and (3) installation and training fees. During 2007, we were required to remit a percentage of the revenues related to the DigiScope to EyeTel under our sales and marketing license with EyeTel. As a result of our acquisition of substantially all of the assets of EyeTel on December 26, 2007, we are no longer required to remit any revenues to EyeTel. In addition, we expanded the market opportunity for the DigiScope into the optometry market in addition to the primary diabetes care physician office market.

Our revenues declined to $44.6 million for the twelve months ended December 31, 2007, compared to $55.2 million for the same period in 2006. Additionally, we incurred a net loss of $8.4 million for the twelve months ended December 31, 2007, compared to net income of $4.3 million for the same period in 2006. We believe that the decline in our revenues has been caused primarily by adverse developments over the past year relating to the reimbursement by third-party payers of nerve conduction studies performed using the NC-stat System, and we expect that our revenues will continue to be adversely affected by the uncertainty regarding reimbursement and by the outcome of the February 2008 AMA CPT Editorial Panel meeting to review the reimbursement coding for nerve conduction studies.

Significant developments impacting and relating to our financial condition and results of operations as of and for the year ended December 31, 2007 and expected to impact future periods include:

- the impact of reimbursement developments relating to nerve conduction studies on our revenues as described above, including the outcome of the AMA CPT Editorial Panel meeting and the material and adverse impact the potential issuance of a Category III CPT code by the AMA is likely to have on our revenues and operating results;

- expanded sales and marketing efforts for the DigiScope as a result of the acquisition of substantially all of the assets and the assumption of certain liabilities of EyeTel and the broader market opportunity we can now address including the optometry market. We expect to continue to increase revenues from the DigiScope and we expect that the gross margin on DigiScope revenues will improve due to our acquisition and the elimination of the amounts we were previously remitting to EyeTel;

- increased capital expenditures relating to purchases of DigiScope units, resulting from the acquisition of substantially all of the assets and the assumption of certain liabilities of EyeTel and our responsibility for all units produced by our third party manufacturer;

- our decision to terminate the relationships with our independent sales agencies in the second half of 2007, which we believe has adversely impacted our revenues, but is expected to reduce sales and marketing expenses in 2008 as a result of the elimination of commissions on recurring revenues from accounts originally sourced through our independent sales agencies. In 2007, total commissions relating to independent sales agencies were $3.0 million;

- the delay of the expected launch of the ADVANCE System, our traditional neurodiagnostic system, for which we have invested approximately $3.0 million in inventories as of December 31, 2007, and for which we continue to seek 510(k) regulatory approval from the FDA;

- the government investigations by the Office of Inspector General, or OIG, of the Department of Health and Human Services and the U.S. Department of Justice, or DOJ, that we are subject to, which resulted in significantly increased legal expenses in 2007. We cannot predict the potential impact of these investigations on our financial condition or financial results in 2008;

- continued progress with our product in development, referred to as NAVIGATOR, a minimally invasive nerve localization system for regional anesthesia, pain control and the treatment of neuropathies such as carpal tunnel syndrome, or CTS, for which we expect to file a 510(k) application with the FDA in 2008. We continue to invest resources on the development of this product; and

- the investment we made in Cyberkinetics in the fourth quarter of 2007, which included the purchase of $2.5 million of Cyberkinetics common stock and the receipt of a warrant to purchase an additional $1.25 million of Cyberkinetics common stock that we must exercise in certain circumstances, as well as the joint venture we have entered into with Cyberkinetics for the development of a treatment for peripheral nerve injury, for which we have committed to fund the first $2.0 million in development expenses and 50% of any development costs exceeding the initial $2.0 million.

Reimbursement from third-party payers is an important element of success for medical products companies. As our presence in the market expands and the use of the NC-stat System increases, we have experienced and are likely to continue to experience an increased focus from third-party payers and governmental agencies regarding the reimbursement of nerve conduction studies performed using the NC-stat System and an increased focus from these organizations regarding the professional requirements for performing nerve conduction studies in general. A number of third-party payers, including commercial payers, have taken and may continue to take the position of not reimbursing our customers for their use of the NC-stat System.

During the second half of 2006 and in 2007, several local Medicare carriers issued draft LCDs, final LCDs or coding articles particularly addressing coverage and reimbursement policies under Medicare for nerve conduction studies performed using the NC-stat System. Several of these carriers indicated that they will not reimburse physicians under Medicare for nerve conduction studies performed using the NC-stat System under the three existing Current Procedural Terminology, or CPT, codes for conventional nerve conduction studies (95900, 95903 and 95904), which provide for levels of reimbursement fixed by the Center for Medicaid and Medicare Services, or CMS, but rather that physicians must submit claims for reimbursement for these procedures under a miscellaneous CPT code (95999), in which case the local carriers may determine the level of reimbursement to be paid, if any. Currently, there are three local Medicare carriers with final LCDs, one local Medicare carrier with a draft LCD, and one local Medicare carrier with a coding article which address coverage and reimbursement policies under Medicare for nerve conduction studies performed using the NC-stat System. One additional Medicare carrier, which had previously issued a final LCD, reversed their position effective June 30, 2007. In certain regions impacted by these reimbursement decisions, our customers have experienced lower levels of reimbursement and higher levels of claims denials. If physicians do not receive adequate reimbursement under the miscellaneous CPT code from those local carriers, our existing customers may continue to limit or curtail their use of the NC-stat System and we may be unable to obtain new customers, both of which could materially and adversely impact our revenues and profitability.

The AMA formed a work group in early 2007 to examine the reimbursement coding of nerve conduction studies and nerve conduction equipment, including the NC-stat System. The findings of this committee were presented to the AMA CPT Editorial Panel at a meeting in February 2008. During the CPT Panel meeting, several proposals for new Category I CPT codes, which generally are included in the Medicare physician fee schedule and are assigned specified reimbursement values, were presented by the chairpersons of the work group and were supported by several physician societies. In spite of this, the only proposal voted on was for the creation of a new Category III CPT code, which generally would not be included on the Medicare physician fee schedule and would not generally have an assigned reimbursement value. At this meeting, we believe that the CPT Panel approved a new Category III CPT Code for nerve conduction studies performed using equipment with certain automated features such as the NC-stat System. Unless we are able to successfully challenge this decision, a new Category III CPT Code would likely be published in July 2008 and become effective in January 2009. In the event that a Category III CPT code is published which describes nerve conduction studies performed with the NC-stat System, it would likely result in limited or no Medicare reimbursement for such studies as a result of the potential that no specified reimbursement values would be assigned to these codes. This could also adversely impact reimbursement by other third party payers and could have an adverse and material impact on our revenues and results of operations.

The LCDs and coding articles issued by local Medicare carriers have also addressed a number of other issues, including (1) the background and training of physicians supervising or performing nerve conduction studies, (2) the level of training requirements for technicians performing a nerve conduction study, (3) whether nerve conduction tests should be required to be performed concomitantly with a needle electromyography procedure and (4) whether the NC-stat System is comparable to conventional nerve conduction testing equipment. We do not believe that these LCDs prohibit physicians from receiving reimbursement under Medicare for medically necessary nerve conduction studies performed using the NC-stat System. However, these LCDs do appear to be targeted at limiting access to perform and/or reimbursement for nerve conduction studies. In certain cases, these LCDs are being interpreted or implemented in a manner that impacts the ability of physicians to receive reimbursement under Medicare, including lower levels of reimbursement and an increase in the number of claims being denied, for nerve conduction studies performed using the NC-stat System, which are having an adverse impact on our revenues.

Additionally, a significant number of commercial payers, including the majority of regional Blue Cross Blue Shield carriers, and other major private payers, have adopted policies indicating that they will not provide reimbursement for the use of the NC-stat System. These commercial payers have cited various reasons for their reimbursement policies, including, among others, that the NC-stat System is experimental and investigational. We are in the process of communicating with these payers, directly, through our customers or through our network of reimbursement consultants, to attempt to address their concerns. Third-party payers may also impose requirements on physicians to submit additional paperwork supporting the medical necessity of nerve conduction studies performed using the NC-stat System. We believe these requirements are negatively impacting the use of the NC-stat System by existing customers and our sales to new customers, both of which are having an adverse impact on our revenues.

Additional third-party payers, including local Medicare carriers and commercial payers, could potentially take a position that could reduce or eliminate the reimbursement for the NC-stat System and could have the impact of deterring usage by our customers which could have an adverse impact on our revenues.

We believe that eye scans performed using the DigiScope are being reimbursed by the majority of third-party payers. Many commercial payers have policies in place providing for reimbursement for the use of the DigiScope and many of these payers have published favorable articles about the DigiScope in their newsletters. However, several Medicare carriers have issued draft LCDs and coding articles that require a diagnosis of pre-existing retinal disease and/or will only reimburse for fundus photography, a highly specialized form of medical imaging, when performed in conjunction with an eye examination performed by an eye specialist. There are no assurances that other Medicare carriers will not issue similar draft LCDs, final LCDs or coding articles restricting the reimbursement for the use of the DigiScope. We believe that eye examinations performed on patients covered by Medicare represented less than 25% of our DigiScope revenues in 2007. However, the restrictions on reimbursement by Medicare carriers could have an adverse impact on our ability to grow our DigiScope revenues in future periods.

One of the primary challenges we face in our business is successfully expanding the market for nerve conduction studies. A successful market expansion will depend upon, in part, our targeting of primary care and specialist physicians who traditionally have not been targeted by companies selling equipment used to perform nerve conduction studies and our ability to alter physicians' practices relating to the diagnosis of neuropathies. Our strategy had been to sell the NC-stat System through a combination of independent sales agencies and a direct sales force of experienced sales representatives. The independent sales agencies, including small to medium sized regional firms and larger national firms, had primarily been responsible for generating sales leads and our direct sales force had been responsible for bringing these sales leads to closure. These independent sales agencies typically had not served in a traditional distribution role and therefore had not been responsible for maintaining inventories, for making shipments to customers or for billing and collection functions.

Our strategy of utilizing independent sales agencies had been effective historically, but we experienced a significant decline in the percentage of new customers being sourced through our independent sales agency network in the first half of 2007. As a result, consistent with our long term business objectives, in the second half of 2007, we made a decision to terminate our relationships with all independent sales agencies and focus our selling efforts exclusively through our direct sales force, which, as of December 31, 2007, was comprised of approximately 50 regional sales managers, five regional sales directors and one national sales director.

We expect that our direct sales force will expand their role in generating new customer sales leads, and we plan to increase efforts to generate sales leads through various marketing activities including mailings and tradeshows. However, we experienced a decline in the number of new customers added in the last several quarters along with a decline in sales to our existing customers. We believe the decision to terminate the independent sales agency relationships may have contributed to these declines and could potentially have an adverse impact on our revenues and our ability to secure new customers in future periods as well.

Business Focus

Our long-term financial objectives are to grow our business through the sale of proprietary medical devices and to achieve and sustain profitability. We expect to achieve these objectives through sales of the NC-stat System and the DigiScope and additional products that may be commercialized to help physicians in the diagnosis and treatment of nervous system disorders, including neuropathies, and neurovascular disorders and products designed to provide regional anesthesia and pain control. However, during 2008 our revenues are likely to continue to decline and we are likely to continue to incur losses as a result of the reimbursement and other issues we are currently facing. Our efforts in 2008 will focus on (1) efforts to manage the reimbursement challenges posed by third-party payers for the NC-stat System after the AMA CPT Editorial Panel issues their final determination on the reimbursement coding for nerve conduction studies performed using automated equipment such as the NC-stat System, (2) sales of the NC-stat System, (3) sales and marketing of the DigiScope for the detection of diabetic retinopathy, including a market expansion into optometry clinics, (4) seeking regulatory clearance from the FDA for our traditional neurodiagnostic system, the ADVANCE System, in order to launch this product into the specialist physician and primary care physician markets and for portions of the onCall Information System, (5) cooperating with, and working to resolve, the government investigations of which we are subject and (6) our ongoing research and development programs, including NAVIGATOR, and a peripheral nerve injury product being jointly developed with Cyberkinetics.

Our launch of the ADVANCE System will depend upon our receipt of regulatory clearance from the FDA. We submitted our initial 510(k) filing for the ADVANCE System in the first quarter of 2007 and FDA clearance is still pending. During the fourth quarter of 2006, at the request of the FDA, we submitted a 510(k) filing relating to portions of the onCall Information System that are currently in use and the 510(k) clearance is still pending. If 510(k) clearance for the portions of the onCall Information System that are under review is not obtained, it may require additional product development and potential changes in the configuration of our products.

With respect to our research and development programs, during 2008, we expect to continue efforts to develop new biosensors, on the development of the ADVANCE System and its accessories, on the development of NAVIGATOR, for which we anticipate filing a 510(k) application with the FDA in 2008, and on a product for the treatment of peripheral nerve injury in collaboration with our joint venture partner, Cyberkinetics.

Results of Operations

The following table presents certain statement of operations information stated as a percentage of total revenues:

	Years Ended December 31,		
	2007	**2006**	**2005**
Revenues:			
Diagnostic device	9.5%	13.6%	12.3%
Biosensor	88.3	86.4	87.7
Other	2.1		
Total revenues	100.0	100.0	100.0
Cost of revenues	27.0	24.5	25.8
Gross margin	73.0	75.5	74.2
Operating expenses:			
Research and development	11.0	9.1	11.1
Sales and marketing	51.5	39.8	41.3
General and administrative	33.2	21.4	23.4
Total operating expenses	95.7	70.3	75.8
Income (loss) from operations	(22.7)	5.2	(1.6)
Interest income, net	3.9	2.9	2.4
Income (loss) before provision for income taxes	(18.8)	8.1	0.8
Provision for income taxes		0.3	0.1
Net income (loss)	(18.8)%	7.7%	0.7%

Comparison of Years Ended December 31, 2007 and December 31, 2006

Revenues

The following tables present a breakdown of our customers, biosensor units used and revenues:

	Years Ended December 31,			
	2007	**2006**	**Change**	**% Change**
Customers	5,555	4,929	626	12.7%
Biosensor units used	1,055,500	1,155,300	(99,800)	(8.6)

	Years Ended December 31,			
	2007	**2006**	**Change**	**% Change**
	(in thousands, except percentage data)			
Revenues:				
Diagnostic device	$ 4,254.0	$ 7,538.3	$ (3,284.3)	(43.6)
Biosensor	39,413.3	47,711.4	(8,298.1)	(17.4)
Other	954.9		954.9	N/A
Total revenues	$ 44,622.2	$ 55,249.7	$ (10,627.5)	(19.2)

Diagnostic device revenues were $4.3 million and $7.5 million for the years ended December 31, 2007 and 2006, respectively, a decrease of $3.3 million, or 43.6%. This decrease is primarily attributable to a lower number of units sold, which we believe resulted primarily from uncertainty and adverse developments relating to the reimbursement for procedures performed with the NC-stat System. Diagnostic device revenues accounted for 9.5% and 13.6% of our total revenues for the years ended December 31, 2007 and 2006, respectively.

Biosensor revenues were $39.4 million and $47.7 million for the years ended December 31, 2007 and 2006, respectively, a decrease of $8.3 million, or 17.4%. This decrease is attributable to lower sales of biosensors, which we believe resulted primarily from uncertainty and adverse developments relating to the reimbursement for procedures performed with the NC-stat System. Biosensor revenues accounted for 88.3% and 86.4% of our total revenues for the years ended December 31, 2007 and 2006, respectively.

Our customers used 1,055,500 biosensor units in the year ended December 31, 2007, compared to 1,155,300 units in the year ended December 31, 2006, a decrease of 99,800 units, or 8.6%. This decrease in biosensor usage is primarily the result of a decline in average usage per customer offset in part by an increase in our customer base. During the 12-month period ended December 31, 2007, a total of 5,555 customers used the NC-stat System compared to 4,929 customers for the same period in 2006. This represents a 12.7% year-over-year increase in the number of customers that used our NC-stat System. The average usage per account declined to 190 biosensors for the year ended December 31, 2007 from 234 biosensors for the same period in 2006.

Other revenues are attributable to the DigiScope, which we had been selling under an exclusive sales and marketing license agreement entered into with EyeTel in October 2006 and we launched our sales and marketing efforts during the first quarter of 2007. Revenues related to the DigiScope were derived from a mix of new customers and customer accounts that existed at the time of our signing of the license agreement with EyeTel and were transferred to us. On December 26, 2007, we acquired substantially all of the assets and assumed certain liabilities of EyeTel, including all the rights to the DigiScope.

Our total revenues were $44.6 million and $55.2 million for the years ended December 31, 2007 and 2006, respectively, a decrease of $10.6 million, or 19.2%. The decline in our total revenues is attributable to the previously mentioned lower number of NC-stat Systems and biosensors sold, which we believe resulted primarily from uncertainty and adverse developments relating to the reimbursement for nerve conduction studies performed with the NC-stat System.

We anticipate that revenues in 2008 will continue to decline. In the fourth quarter of 2007, we experienced a decline in revenues of 10.5% from the third quarter of 2007, which we believe primarily resulted from the uncertainty created by the issuance of draft LCDs, final LCDs and coding articles addressing reimbursement for nerve conduction studies and policies issued by commercial payers intended to deter usage or limit the reimbursement for the NC-stat System. These developments and other future reimbursement decisions, including the potential issuance of a Category III CPT code by the AMA CPT Editorial Panel, could continue to adversely impact reimbursement for procedures performed using the NC-stat System. Our revenues in 2008 are likely to be impacted by (a) the potential issuance of a Category III CPT code by the AMA CPT Editorial Panel; (b) the level of reimbursement, if any, established for procedures performed using the NC-stat System by insurance carriers and other third-party payers; (c) whether final LCDs are applied in a manner that places additional restrictions or qualifications on the performance of these procedures; (d) any other reimbursement determinations relating to nerve conduction studies that may be issued by third-party payers; or (e) any other events causing uncertainty as to the existence or amount of reimbursement physicians are likely to receive for performing procedures using the NC-stat System. Separately, we expect revenues to continue to be positively impacted by expanded sales and marketing efforts in the optometry market for the DigiScope. Overall, revenues could be impacted by a variety of factors, including the level of demand for our products, potential for changes in third-party reimbursement for nerve conduction studies, the decision to terminate our relationships with independent sales agencies, the overall economy, competitive factors and the factors described in the section of this Annual Report on Form 10-K titled "Cautionary Note Regarding Forward-Looking Statements."

Costs and expenses

The following table presents our costs and expenses and net income (loss):

	Years Ended December 31,			
	2007	2006	Change	% Change
		(in thousands)		
Cost of revenues:				
Diagnostic device	$ 915.8	$ 1,320.5	$ (404.7)	(30.7)%
Biosensor	10,422.1	12,237.6	(1,815.5)	(14.8)
Other	724.0		724.0	N/A
Total cost of revenues	12,061.8	13,558.1	(1,496.3)	(11.0)
Gross margin:				
Diagnostic device	3,338.2	6,217.8	(2,879.6)	(46.3)
Biosensor	28,991.2	35,473.9	(6,482.6)	(18.3)
Other	231.0		231.0	N/A
Total gross margin	32,560.4	41,691.7	(9,131.2)	(21.9)
Gross Margin %:				
Diagnostic device	78.5%	82.5%		
Biosensor	73.6	74.4		
Other	24.2			
Total gross margin	73.0	75.5		
Operating expenses:				
Research and development	$ 4,891.9	$ 5,010.5	$ (118.6)	(2.4)
Sales and marketing	22,963.8	22,013.7	950.2	4.3
General and administrative	14,834.1	11,805.1	3,029.0	25.7
Total operating expenses	42,689.9	38,829.3	3,860.6	9.9
Income (loss) from operations	(10,129.4)	2,862.4	(12,991.8)	(453.9)
Interest income	1,751.0	1,598.4	152.6	9.5
Income (loss) before provision for income taxes	(8,378.5)	4,460.8	(12,839.3)	(287.8)
Provision for income taxes		193.0	(193.0)	(100.0)
Net income (loss) available to common stockholders	$ (8,378.5)	$ 4,267.8	$ (12,646.3)	(296.3)

Gross Margin

Diagnostic device gross margin decreased to $3.3 million, or 78.5% of diagnostic device revenue, for the year ended December 31, 2007, as compared to $6.2 million, or 82.5% of diagnostic device revenue, for same period in 2006. The decrease in the gross margin percentage is primarily attributable to a decrease in the number of devices sold.

Biosensor gross margin decreased to $29.0 million, or 73.6% of biosensor revenue, for the year ended December 31, 2007, as compared to $35.5 million, or 74.4% of biosensor revenue, for the same period in 2006. The decrease in the biosensor gross margin percentage is primarily due to lower sales volumes and higher product warranty costs.

Other gross margin percentage, which related entirely to the DigiScope, was 24.2% for the year ended December 31, 2007. DigiScope revenues in 2007 represent monthly rental fees and eye scan fees as well as the amortization of deferred revenues relating to installation and training fees. Under the

60

terms of agreement, we were required to remit a percentage of the revenues related to the DigiScope to EyeTel. The agreement included a provision for a higher percentage of the scan fees to be remitted to EyeTel for these existing customers for the first nine months of 2007. Effective October 1, 2007, consistent with the terms of our original agreement with EyeTel, the percentage of revenues we retained from these existing customers increased from 25% to 50%, which resulted in an increase in gross margins on DigiScope revenues in the fourth quarter of 2007 to 30.7% from 25.0% in the third quarter of 2007. As a result of our December 26, 2007 acquisition of substantially all of the assets of EyeTel, we expect gross margin on DigiScope revenues will increase in 2008.

Our overall gross margin decreased to $32.6 million, or 73.0% of revenues, for the year ended December 31, 2007, as compared to $41.7 million, or 75.5% of revenues, for same period in 2006.

Our gross margins may continue to decline during 2008 due to the expected decline in revenues derived from the NC-stat System and due to an expected increase in the percentage of total revenues derived from the DigiScope, which has lower gross margins as compared with our other products.

Research and Development

Our research and development, or R&D, expenses include expenses associated with our research, product development, clinical, regulatory, and quality assurance departments.

R&D expenses decreased $118,600, or 2.4%, to $4.9 million for the year ended December 31, 2007 from $5.0 million for the year ended December 31, 2006. As a percentage of revenues, R&D expenses were 11.0% and 9.1% for the years ended December 31, 2007 and 2006, respectively. The decrease in R&D expenses for the year ended December 31, 2007 compared with the same period in 2006, was primarily due to a decrease of $178,400 related to developmental costs expended on the ADVANCE System and on new biosensors. This decrease was offset in part by an increase of $81,000 in personnel costs resulting from the hiring of additional employees in our R&D department and related to increases in employee compensation.

We expect our spending on R&D will be relatively unchanged during 2008. We anticipate that resources devoted to the development of the ADVANCE System may be reallocated to other research and development efforts. This amount may vary, however, depending on the opportunities and challenges that arise during the year and depending on the outcome of the FDA review of our 510(k) submission for the ADVANCE System, the FDA review of our 510(K) submission for portions of the onCall Information System and our revenues during 2008.

Sales and Marketing

Our sales and marketing expenses include expenses from the marketing, field sales, sales administration and reimbursement departments.

Sales and marketing expenses increased $950,200, or 4.3%, to $23.0 million for year ended December 31, 2007 from $22.0 million for the year ended December 31, 2006. As a percentage of revenues, sales and marketing expenses were 51.5% and 39.8% for the years ended December 31, 2007 and 2006, respectively. The increase in expenses was primarily due to (a) an increase of $1.4 million in employee compensation and benefit costs attributable to the expansion of our sales force; (b) an increase of $511,100 in consulting services, primarily to assist us with the reimbursement challenges we are facing; (c) an increase of $245,400 in stock-based compensation expense; and (d) an increase of $335,400 in advertising and promotional expenses. These amounts were partially offset by a decrease in third-party sales commissions of $2.0 million, primarily due to our decision to terminate our relationships with all independent sales agencies and focus our selling efforts exclusively through our direct sales force and also due to decreased revenues.

We anticipate that our sales and marketing expenses may decline in 2008 as a result of reduced payments to independent sales agencies and reduced commissions to our direct sales force attributable to potentially lower revenues, however, this may vary, depending primarily upon on our revenues for 2008.

Our sales force is comprised of 56 employees, including 50 regional sales managers, as of December 31, 2007 compared to 53 employees, including 50 regional sales managers as of December 31, 2006. We plan to continue selling the DigiScope through the same sales force used to sell the NC-stat System and as a result we do not anticipate the need to expand the sales force to support the sales and marketing efforts for the DigiScope.

General and Administrative

Our general and administrative expenses include expenses from the executive, finance, administrative, customer service, and information technology departments.

General and administrative expenses increased $3.0 million, or 25.7%, to $14.8 million for year ended December 31, 2007 from $11.8 million for the year ended December 31, 2006. As a percentage of revenues, general and administrative expenses were 33.2% and 21.4% for the years ended December 31, 2007 and 2006, respectively. The increase in expenses was primarily due to an increase of $5.2 million in professional fees, mainly legal services, an increase of $425,000 in consulting expenses and an increase of $191,800 in stock-based compensation expense. The increases in professional fees and consulting services are both primarily related to the government investigations previously disclosed by us and to reimbursement matters. Partially offsetting these increases was a reversal of $1.7 million of sales tax liability as a result of receiving amnesty from a number of states and receiving relief from other states in the form of a limited look back period and waiver of penalties and a $585,200 decrease in bad debt expense.

We believe our general and administrative expenses will increase in 2008 as a result of our acquisition of substantially all of the assets of EyeTel and may increase or decrease depending upon the amount incurred for professional fees and consulting services relating to the government investigations and reimbursement matters previously disclosed by us.

Interest Income

Interest income was $1.8 million and $1.6 million during the years ended December 31, 2007 and 2006, respectively. Interest income was earned from cash equivalents and short-term investments. The increase in interest income for the year ended December 31, 2007, as compared to the same period in 2006, was primarily due to higher average invested cash balances combined with an increase in the average portfolio yield, attributable to a shift in the portfolio mix to higher yielding fixed maturities, and the prevailing interest rate environment primarily during the first half of 2007.

Provision for Income Taxes

We recorded no tax provision for the year ended December 31, 2007 due to the net loss incurred. We recorded a tax provision related to the alternative minimum tax of $193,000 for the year ended December 31, 2006.

Comparison of Years Ended December 31, 2006 and December 31, 2005

Revenues

The following tables present a breakdown of our customers, biosensor units used and revenues:

	Years Ended December 31,			
	2006	2005	Change	% Change
Customers	4,929	3,282	1,647	50.2%
Biosensor units used	1,155,300	704,800	450,500	63.9

	Years Ended December 31,			
	2006	2005	Change	% Change
	(in thousands, except percentage data)			
Revenues:				
Diagnostic device	$ 7,538.3	$ 4,221.3	$ 3,317.0	78.6
Biosensor	47,711.4	30,076.8	17,634.6	58.6
Total revenues	$ 55,249.7	$ 34,298.1	$ 20,951.6	61.1

Diagnostic device revenues were $7.5 million and $4.2 million for the years ended December 31, 2006 and 2005, respectively, an increase of $3.3 million, or 78.6%. Of this increase, approximately $2.6 million is attributable to a greater number of units sold, primarily as a result of increased demand for the NC-stat System and an increase in the number of regional sales managers. In addition, $0.7 million of this increase is attributable to an increase in the list price of our NC-stat monitors and docking stations from $4,000 to $5,000 effective January 1, 2006, which resulted in a higher average selling price during 2006 as compared to 2005. Diagnostic device revenues accounted for 13.6% and 12.3% of our total revenues for the years ended December 31, 2006 and 2005, respectively.

Biosensor revenues were $47.7 million and $30.1 million for the years ended December 31, 2006 and 2005, respectively, an increase of $17.6 million, or 58.6%. The increase is primarily due to an increased customer base for our biosensors and an increased frequency of testing by our customers. Biosensor revenues accounted for 86.4% and 87.7% of our total revenues for the years ended December 31, 2006 and 2005, respectively.

Our customers used 1,155,300 biosensor units in the year ended December 31, 2006, compared to 704,800 units in the year ended December 31, 2005, an increase of 450,500 units, or 63.9%. The increase in biosensor usage is primarily attributable to the increase in our customer base and to an increase in usage per customer. During the 12-month period ending December 31, 2006, a total of 4,929 customers used our NC-stat System compared to 3,282 customers for the same period ending December 31, 2005. This represents a 50.2% year-over-year increase in the number of customers that used our NC-stat System. The average usage per account increased to 234 biosensors for the year ended December 31, 2006 from 215 biosensors for the same period in 2005.

Our total revenues were $55.2 million and $34.3 million for the years ended December 31, 2006 and 2005, respectively, an increase of $21.0 million, or 61.1%.

Costs and expenses

The following table presents our costs and expenses and net income:

	Years Ended December 31,			
	2006	2005	Change	% Change
		(in thousands)		
Cost of revenues:				
Diagnostic device	$ 1,320.5	$ 1,059.7	$ 260.8	24.6%
Biosensor	12,237.6	7,798.4	4,439.2 4	56.9
Total cost of revenues	13,558.1	8,858.1	4,700.0	53.1
Gross margin:				
Diagnostic device	6,217.8	3,161.6	3,056.2	96.7
Biosensor	35,473.9	22,278.5	13,195.4	59.2
Total gross margin	41,691.7	25,440.0	16,251.6	63.9
Gross Margin %:				
Diagnostic device	82.5%	74.9%		
Biosensor	74.4	74.1		
Total gross margin	75.5	74.2		
Operating expenses:				
Research and development	$ 5,010.5	$ 3,820.6	$ 1,189.9	31.1
Sales and marketing	22,013.7	14,150.2	7,863.5	55.6
General and administrative	11,805.1	8,021.8	3,783.3	47.2
Total operating expenses	38,829.3	25,992.6	12,836.7	49.4
Income from operations	2,862.4	(552.5)	3,414.9	(618.1)
Interest income	1,598.4	838.8	759.6	90.6
Interest expense		(2.0)	2.0	(100.0)
Income before provision for income taxes	4,460.8	284.3	4,176.5	1,469.3
Provision for income taxes	193.0	35.0	158.0	451.4
Net income available to common stockholders	$ 4,267.8	$ 249.3	$ 4,018.5	1,612.2

Gross Margin

Diagnostic device gross margin increased to $6.2 million, or 82.5% of diagnostic device revenue, for the year ended December 31, 2006, as compared to $3.2 million, or 74.9% of diagnostic device revenue, for same period in 2005. The increase in the gross margin percentage in 2006 compared to 2005 is primarily attributable to an increase in the list price of our NC-stat System from $4,000 to $5,000 effective January 1, 2006 and manufacturing price reductions realized for our device beginning in the second quarter of 2006.

Biosensor gross margin increased to $35.5 million, or 74.4% of biosensor revenue for the year ended December 31, 2006, as compared to $22.3 million, or 74.1% of biosensor revenue, for the same period in 2005. The increase in biosensor gross margin percentage is primarily due to manufacturing price reductions realized for several of our biosensors during the second half of 2005 and the first quarter of 2006 partially offset by a change in the mix of biosensors sold.

Our overall gross margin increased to $41.7 million, or 75.5% of revenues, for the year ended December 31, 2006, as compared to $25.4 million, or 74.2% of revenues, for same period in 2005.

Research and Development

R&D expenses increased $1.2 million, or 31.1%, to $5.0 million for the year ended December 31, 2006 from $3.8 million for the year ended December 31, 2005. As a percentage of revenues, R&D expenses were 9.1% and 11.1% for the years ended December 31, 2006 and 2005, respectively. The increase in expenses is primarily due to an increase of $614,000 in personnel costs resulting from the hiring of additional employees in our R&D department and increases in employee compensation. In addition, product development and temporary labor costs increased $77,700 and $51,700, respectively. These increases are primarily related to the development of the ADVANCE System and new biosensors. Also contributing to the increase was an increase of $393,200 in stock-based compensation expense due to the adoption of the provisions of Statement of Financial Accounting Standards, or SFAS, No. 123(R), "*Share Based Payment*," or SFAS No. 123(R).

Sales and Marketing

Sales and marketing expenses increased $7.9 million, or 55.6%, to $22.0 million for year ended December 31, 2006 from $14.2 million for the year ended December 31, 2005. As a percentage of revenues, sales and marketing expenses were 39.8% and 41.3% for the years ended December 31, 2006 and 2005, respectively. The change in expenses is primarily due to an increase of $4.1 million in employee compensation and benefit costs, including sales commissions paid to our regional sales managers. This increase is attributable to the expansion of the sales force and higher revenues in 2006 as compared to 2005. Also contributing to the change in expenses are (a) an increase of $1.6 million in sales commissions paid to our independent regional sales agencies, which is related to our higher revenues in 2006 as well as the addition of a distributor in May 2006; (b) an increase in stock-based compensation expense of $653,300 due to the adoption of the provisions of SFAS No. 123(R); (c) an increase of $400,700 in travel expenses due to the expansion of the sales force; (d) an increase in consulting services of $299,300, primarily to assist us with reimbursement matters; and (e) an increase of $267,500 in costs for new promotional materials.

General and Administrative

General and administrative expenses increased $3.8 million, or 47.2%, to $11.8 million for year ended December 31, 2006 from $8.0 million for the year ended December 31, 2005. As a percentage of revenues, general and administrative expenses were 21.4% and 23.4% for the years ended December 31, 2006 and 2005, respectively. The increase in expenses is primarily due to (a) an increase in stock-based compensation expense of $1.2 million from the adoption of the provisions of SFAS No. 123(R); (b) an increase of $661,300 in bad debt expense resulting from an increase in past due accounts; (c) an increase of $538,400 in professional fees for legal services; (d) an increase of $456,000 in our accrual for sales taxes; (e) an increase of $268,800 in our insurance costs; (f) an increase in credit card and bank fees of $238,800 related to increased customer transactions; and (g) an increase in personnel costs of $120,700 from the expansion of staff and increases in employee compensation.

Interest Income

Interest income was $1,598,400 and $838,800 during the years ended December 31, 2006 and 2005, respectively, representing an increase of $759,600. Interest income was earned from cash equivalents, short-term investments and long-term investments. The increase in interest income for the year ended December 31, 2006, as compared to the year ended December 31, 2005 is primarily due to higher average cash balances and an increase in the average portfolio yield attributable to the impact of higher market interest rates in 2006. Interest expense was not material for the years ended December 31, 2006 and 2005.

Provision for Income Taxes

We recorded a tax provision related to alternative minimum tax of $193,000 and $35,000 for the years ended December 31, 2006 and 2005, respectively.

Liquidity and Capital Resources

Our principal source of liquidity is our current cash and cash equivalents and short-term held-to-maturity investments. As of December 31, 2007, the weighted average maturity of our short-term held-to-maturity investments was 136 days. Our ability to generate cash from operations is dependent upon our ability to generate revenue from sales of our products, as well as our ability to manage our operating costs and net assets. A decrease in demand for our products or unanticipated increases in our operating costs would likely have an adverse effect on our liquidity and cash generated from operations. The following sets forth information relating to our liquidity:

	December 31,			
	2007	2006	Change	% Change
		(in thousands)		
Cash and cash equivalents	$ 7,097.2	$ 7,909.8	$ (812.6)	(10.3)%
Short-term held-to-maturity investments	22,621.7	32,410.7	(9,788.9)	(30.2)
Total cash, cash equivalents and short-term held-to-maturity investments	$ 29,718.9	$ 40,320.5	$ (10,601.5)	(26.3)%

During 2007, our cash and cash equivalents and short-term held-to-maturity investments decreased by $10.6 million, primarily due to $8.0 million of cash used in operations, $2.5 million of cash used for our investment in Cyberkinetics common stock, $257,500 of cash used for capital expenditures and $175,000 of cash used to fund our acquisition of substantially all of the assets of EyeTel, offset partially by $285,900 of proceeds received from the issuance of common stock under our employee stock purchase plan and the exercise of stock options. The current estimated market value of the $2.5 million investment made in Cyberkinetics common stock is approximately $1.4 million and we are restricted from selling this investment until November 2008.

In managing our working capital, two of the financial measurements we monitor are days' sales outstanding, or DSO, and inventory turnover rate, which are presented in the table below for the years ended December 31, 2007 and 2006:

	Years Ended December 31,	
	2007	2006
Days' sales outstanding (days)	54	40
Inventory turnover rate (times per year)	2.7	4.3

Our payment terms extended to our customers generally require payment within 30 days from invoice date. At December 31, 2007, we experienced an increase in DSO to 54 days from 40 days at December 31, 2006 attributable to a significant increase in the percentage of accounts receivable past due 60 days that began during the fourth quarter of 2006. We believe that these increases were primarily the result of challenges surrounding the reimbursement by Medicare and commercial payers in certain regions of the United States for nerve conduction studies performed using the NC-stat System. As long as we continue to face these reimbursement challenges our DSO and our working capital may continue to be adversely impacted. Accounts payable are normally paid within 30 to 40 days from receipt of a vendor's invoice.

Our inventory turnover for the year ended December 31, 2007 was 2.7 times, compared with 4.3 times for the year ended December 31, 2006. The decrease in the inventory turnover rate for the year ended December 31, 2007, as compared to the year ended December 31, 2006, was primarily due to the initial production of the ADVANCE System and decreased demand for the NC-stat System, offset in part by a decline in inventories of biosensors due to production challenges being experienced by our third-party manufacturer resulting from their transition to a new manufacturing facility.

The following sets forth information relating to the sources and uses of our cash.

	Years Ended December 31,		
	2007	2006	2005
	(in thousands)		
Net cash provided by (used in) operating activities	$ (7,989.1)	$ 7,297.9	$ 1,908.1
Net cash provided by (used in) investing activities	$ 6,898.2	$ (9,133.4)	$ 3,514.5
Net cash provided by financing activities	$ 278.3	$ 1,575.3	$ 812.2

Our operating activities used $8.0 million of cash in 2007 while providing cash of $7.3 million and $1.9 million in 2006 and 2005, respectively. In 2007, a net loss of $8.4 million and a net use of cash of $3.4 million for our investment in working capital were offset by $3.8 million in non-cash items, mainly compensation expense associated with stock options. The primary driver for the use of cash in our investment in working capital was a decrease in accrued expenses of $3.4 million. This decrease was primarily due to the reversal of $1.7 million of sales tax liability as a result of receiving amnesty from a number of states and receiving relief from other states in the form of a limited look back period and waiver of penalties. Also impacting working capital was an increase in our inventories of $1.7 million primarily for the production of the ADVANCE System. These items were offset by a $1.6 million decrease in accounts receivable, excluding the provision for doubtful accounts, due to a decline in revenues. In 2006, a net use of cash of approximately $1.2 million for our investment in working capital was offset by $4.3 million in net income and $4.2 million in non-cash items, mainly compensation expense associated with stock options. The primary drivers of our investment in working capital were as follows: our accounts receivable increased $4.1 million, excluding the change in the allowance for doubtful accounts, primarily due to growth in revenues and our inventories increased $950,000 primarily due to the growth in our business and our preparation for the release of the ADVANCE System. These items were partially offset by a $2.1 million increase in accrued expenses. In 2005, increases in accrued expenses, deferred revenue (net of deferred costs) and accounts payable of $1.9 million, $588,900 and $799,300, respectively; non-cash items of $1.4 million and net income of $249,300 were offset in part by increases in accounts receivable and inventory of $1.7 million and $1.4 million, respectively.

As a result of the decline in revenues and increase in operating expenses, we incurred a net loss in 2007 and we expect to incur increased net losses for 2008. This is expected to have an adverse impact on our cash flows from operating activities for 2008.

Our investing activities provided $6.9 million of cash in 2007, used $9.1 million of cash in 2006 and provided $3.5 million of cash in 2005. In 2007, $37.8 million in investment maturities provided cash which was offset in part by $28.0 million in investment purchases, $2.5 million used to fund our investment in Cyberkinetics, $257,500 used to fund purchases of fixed assets, primarily related to computer equipment and tooling equipment for new products and $175,000 used to fund the acquisition of substantially all of the assets of EyeTel. In 2006, $42.1 million in investment purchases and $620,500 used to fund purchases of fixed assets, primarily related to computer equipment, were partially offset by $33.6 million in cash provided from investment maturities. In 2005, $18.8 million in investment maturities provided cash which was offset by $15.3 million in investment purchases, which was primarily reinvested in cash equivalents and $475,100 used to fund purchases of fixed assets primarily related to leasehold improvements and tooling equipment for new products.

During 2008, we expect to continue to maintain our cash and investments in money market funds and short-term investment vehicles. We currently have a commitment of approximately $487,600 to purchase DigiScopes from our manufacturer in China. We expect that our capital expenditures will increase in 2008 compared with 2007 due to the purchases of DigiScopes. We anticipate a total capital investment for DigiScopes in 2008 of $1.6 million to $2.0 million, including the commitment referred to above. Additionally we have a potential commitment to purchase an additional $1.25 million of Cyberkinetics common stock that we must exercise in certain circumstances.

In February 2008, our property lease, originally entered into at the beginning of January 2001 and which was scheduled to expire on March 31, 2009, was amended to extend the term of the lease for a period of an additional four years. In connection with this amendment, the amount of the irrevocable standby letter of credit, we are required to maintain, stating the lessor as the beneficiary, will be reduced from $1,430,000 to $400,000. The letter of credit must be secured by a certificate of deposit in an amount equal to 102% of the letter of credit as a security deposit. We expect that this reduction in the security deposit of approximately $1.0 million will become available to us for our operating and working capital needs during the first half of 2008. The lease will now expire in March 2013. The certificate of deposit is renewable annually. This amount is classified as restricted cash in the balance sheet.

Our financing activities provided $278,300, $1.6 million and $812,000 of cash in 2007, 2006 and 2005, respectively. Cash provided by financing activities in 2007, 2006 and 2005 represent the proceeds from the issuance of shares under our employee stock purchase plan and the exercise of stock options. In 2007, these proceeds were offset in part by payments on a capital lease.

During 2008, we plan to fund sales and marketing efforts for the DigiScope and continue our research and development programs, including the ADVANCE System. We plan to continue investing resources on the development of NAVIGATOR, a minimally invasive nerve localization system for regional anesthesia, pain control and the treatment of neuropathies such as CTS. We also expect to incur capital expenditures for computer hardware and software to support our business and the additional requirements of our customer base. We also continue to explore investment, licensing and acquisition opportunities that may expand our product offering in the physician office market and in the neurological sector.

We expect to continue to incur net losses and negative cash flows from operations for the foreseeable future. Based upon our current plans, we believe that our existing capital resources, including cash and cash equivalents and short-term investments, as of December 31, 2007 are sufficient to finance our ongoing operations for twenty-four months, including the anticipated operating expenses and capital expenditures described above. However, our business is currently facing significant challenges and uncertainties and, as a result, our available capital resources may be consumed more rapidly than currently expected due to changes in our estimates, future revenues, changes we make to our ongoing operating expenses, future changes in our business strategy, decisions we make regarding the size of our sales force and the magnitude of our sales and marketing programs, research and development spending plans, the outcome of the DOJ investigation that we are currently subject to, and other items affecting our level of expenditures and our use of existing cash and cash equivalents and short-term investments. Accordingly, we may need to raise additional funds to support our operating and capital needs. Without additional funds, we may be forced to delay, scale back or eliminate some of our sales and marketing efforts, research and development activities or other operations and potentially delay our product development efforts.

We may attempt to obtain additional funding through public or private financing, collaborative arrangements with strategic partners or through additional credit lines or other debt financing sources to increase the funds we have available to us to fund our operations. However, there are no assurances that we will be able to secure such financing on favorable terms, if at all.

As of December 31, 2007, we have federal and state net operating loss carryforwards available to offset future taxable income of $37.0 million and $21.1 million, respectively, and federal and state research and development credits of $598,000 and $544,000, respectively, which may be available to reduce future taxable income and the related taxes thereon. The net operating loss and research and development credit carryforwards expire at various dates beginning in 2011 for federal and 2008 for state. Ownership changes in our company, as defined in the Internal Revenue Code, are expected to have a modest limitation on the amount of net operating loss and research and development credit carryforwards that can be utilized annually to offset future taxable income and taxes, based on an analysis of the provisions of Section 382 of the Internal Revenue Code. Subsequent changes in our ownership could further affect the limitation in future years.

To date, inflation has not had a material impact on our financial operations.

Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

As of December 31, 2007, we did not have any off-balance sheet financing arrangements.

The following table summarizes our principal contractual obligations as of December 31, 2007 and the effects such obligations are expected to have on our liquidity and cash flows in future periods.

	Payments due in					
Contractual Obligations	**Total**	**2008**	**2009**	**2010**	**2011 & 2012**	**after 2012**
Operating lease obligations	$ 1,162,500	$ 930,000	$ 232,500	$	$	$
Capital lease obligations	31,175	12,900	12,900	5,375		
Purchase order obligations	3,369,946	3,369,946				
Total contractual obligations	$ 4,563,621	$ 4,312,846	$ 245,400	$ 5,375	$	$

In connection with our investment in Cyberkinetics, we received a warrant to purchase up to approximately 2.7 million shares of Cyberkinetics common stock. The warrant, exercisable at $0.46 per share, or approximately $1.25 million, has a term of five years, and is required to be exercised by us if Cyberkinetics receives FDA approval of an HDE filing for the Andara OFS device for acute spinal cord injuries.

In February 2008, we entered into a Collaboration Agreement and Operating Agreement with Cyberkinetics to develop and commercialize products for the treatment of peripheral nerve injury and formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture with initial ownership of 50% held by us and 50% held by Cyberkinetics. Under the terms of the joint venture, we have agreed to fund the initial $2.0 million in product development costs and have agreed to share equally in all costs in excess of the initial $2.0 million.

In February 2008, we amended the Lease Agreement dated October 18, 2000 between Fourth Avenue LLC and us for office and engineering laboratory space. The amendment extends the term of the lease, currently scheduled to expire on March 31, 2009, through March 31, 2013. Base rent for the period April 2009 through March 2013 will be reduced from the current level of $930,000 annually to a range of $675,000 to $765,000 annually.

Critical Accounting Policies

Our financial statements are based on the selection and application of generally accepted accounting principles, which require us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and the accompanying notes. Future events and their effects cannot be determined with certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates, and any such differences may be material to our financial statements. We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements. If different assumptions or conditions were to prevail, the results could be materially different from our reported results. Our significant accounting policies are presented within Note 1 to our Financial Statements.

Revenue Recognition

Our revenue recognition policy is to recognize revenues from our NC-stat System monitors and biosensors upon shipment if the fee is fixed or determinable, persuasive evidence of an arrangement exists, delivery has occurred and risk of loss has passed, collection of the resulting receivables is reasonably assured and product returns are reasonably estimable. Revenues from our docking station and access to the onCall Information System are considered one unit of accounting and are deferred and recognized over the shorter of the estimated customer relationship period or the estimated useful life of the product, currently three years. We record revenue on a net basis for product sales made to distributors, based upon the amount billed to the distributors, when the distributor accepts the responsibility for invoicing the customer and the responsibility for the risk of collections and product returns from the customer.

When multiple elements are contained in a single arrangement, we allocate revenue between the elements based on their relative fair value, provided that each element meets the criteria for treatment as a separate unit of accounting. An element is considered a separate unit of accounting if it has value to the customer on a stand-alone basis, there is objective, reliable evidence of the fair value of the undelivered elements and delivery or performance of the undelivered elements is considered probable and substantially in our control. Fair value is determined based upon the price charged when the element is sold separately.

Revenue recognition involves judgments, including assessments of expected returns, allowance for doubtful accounts and expected customer relationship periods. We analyze various factors, including a review of specific transactions, our historical returns, average customer relationship periods, customer usage, customer balances and market and economic conditions. Changes in judgments or estimates on these factors could materially impact the timing and amount of revenues and costs recognized. Should market or economic conditions deteriorate, our actual return or bad debt experience could exceed our estimate.

Certain product sales are made with a 30-day right of return. Since we can reasonably estimate future returns, we recognize revenues associated with product sales that contain a right of return upon shipment and at the same time reduce revenue by the amount of estimated returns under the provisions of SFAS No. 48, "*Revenue Recognition When Right of Return Exists*."

Other revenues consist entirely of revenues relating to the DigiScope, including installation and training fees, per patient fees for eye scans performed using the DigiScope and monthly rental fees for the use of the DigiScope. Installation and training fees are deferred and recognized on a straight line basis over the non-cancelable term of the customer contract, currently one year. Revenues from fees charged for patient eye scans are recognized as the scans are performed. Fees for the rental of the DigiScope are recognized on a monthly basis. Under the terms of an exclusive sales and marketing license to the DigiScope from EyeTel, amounts due to EyeTel were recorded as cost of sales.

Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We review our allowance for doubtful accounts and determine the allowance based on an analysis of customer past payment history, product usage activity, and recent communications between us and the customer. Past due balances over 90 days are reviewed individually for collectibility. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered. We do not have any off-balance sheet credit exposure related to our customers.

Warranty Costs

We accrue for device and biosensor warranty costs at the time of sale. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, user error, variability in physiology and anatomy of customers' patients, material usage and delivery costs. Should actual product failure and user error rates, material usage or delivery costs differ from our estimates, the amount of actual warranty costs could materially differ from our estimates. Warranty costs are based on the cost of repairing or replacing monitors and docking stations and based on the replacement cost of biosensors.

Asset Valuation

Asset valuation includes assessing the recorded value of certain assets, including short and long-term investments, accounts receivable, inventories and fixed assets. We use a variety of factors to assess valuation, depending upon the asset. Our investment portfolio is classified as held-to-maturity, and such investments are stated at amortized cost. In accordance with the provisions of SFAS No. 115, "*Accounting for Certain Investments in Debt and Equity Securities*", or SFAS No. 115, our investment in Cyberkinetics is classified as available-for-sale and is carried at fair value, with any unrealized gains and losses, net of taxes, reported in accumulated other comprehensive loss, a separate component of stockholders' equity. Accounts receivable are evaluated based upon our historical experience, the age of the receivable and current market and economic conditions. The realizable value of inventories is based upon the types and levels of inventory held, forecasted demand, pricing, competition and changes in technology. Should current market and economic conditions deteriorate, our actual recoveries could be less than our estimates. The recoverability of our fixed assets and other long-lived assets are evaluated when circumstances indicate that an event of impairment may have occurred in accordance with the provisions of SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*", or SFAS No. 144.

Accounting for Income Taxes

As part of the process of preparing our financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure, including assessing the risks associated with tax audits, together with assessing temporary differences resulting from the different treatment of items for tax and accounting purposes. These differences, together with cumulative net operating losses, result in deferred tax assets and liabilities, which are included within our balance sheet. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not more likely than not, establish a valuation allowance. The primary factor used in the determination of the valuation allowance is our historical profitability. In the event that actual results differ from these estimates, our provision for income taxes could be materially impacted.

Effective January 1, 2007, we adopted FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*", or FIN 48, which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 requires us to perform a two-step evaluation of all tax positions, ensuring that these tax return positions meet the "more-likely than not" recognition threshold and can be measured with sufficient precision to determine the benefit recognized in the financial statements. These evaluations provide us with a comprehensive model for how we should recognize, measure, present, and disclose in our financial statements certain tax positions that we have taken or expect to take on income tax returns. Management estimated that as of December 31, 2006, there was an uncertain tax position totaling approximately $100,000 relating to our tax credit carryforwards. As a result, we reduced our deferred tax assets and the associated valuation allowance by approximately $100,000 as of January 1, 2007, the adoption date of FIN 48. There have been no other activities impacting FIN 48 reserves during the year ended December 31, 2007.

Accounting for Stock-Based Compensation

Effective January 1, 2006, we adopted SFAS No. 123(R) using the modified prospective method and began reflecting the stock-based compensation expense determined under fair value based methods in our statement of operations rather than as pro forma disclosure in our notes to the financial statements. Under this transition method, the compensation cost recognized beginning January 1, 2006 includes compensation cost for (i) all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123, "*Accounting for Stock-Based Compensation*", or SFAS No. 123, and (ii) all share based payments granted or modified subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost is generally recognized ratably over the requisite service period. Prior period amounts have not been restated. We use the Black-Scholes option pricing model for determining the fair value of our stock options and amortize our stock-based compensation expense using the straight-line method.

Goodwill and Other Intangible Assets

As result of our acquisition of substantially all of the assets of EyeTel on December 26, 2007, there was approximately $5.8 million of goodwill and $2.8 million of other intangible assets on our balance sheet at December 31, 2007. We will amortize intangible assets using the straight-line method over their estimated economic lives, which is currently estimated to be five years. Determining the economic lives of acquired intangible assets requires us to make significant judgment and estimates, and can materially impact our operating results.

SFAS No. 142, "*Goodwill and Other Intangible Assets*", or SFAS No. 142, requires us to assess the realizability of goodwill annually, as well as whenever events or changes in circumstances suggest that the carrying amount may not be recoverable. The Company's ability to realize the value of the goodwill will depend on the future cash flows of the business. If the Company is not able to realize the value of goodwill, the Company may be required to incur material charges relating to the impairment of goodwill.

We are required to perform impairment tests under SFAS No. 142 annually and whenever events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. For the acquisition, various analyses, assumptions and estimates were made at the time of the acquisition specifically regarding product development, market conditions and expected cash flows that were used to determine the valuation of goodwill and intangibles.

When we perform impairment tests in future years, changes in forecasts and estimates from those used at the acquisition date could result in impairment charges.

Other Long-Lived Assets

We periodically evaluate long-lived assets for potential impairment under SFAS No. 144. We plan to perform these evaluations whenever events or changes in circumstances suggest that the carrying value of an asset or group of assets is not recoverable. If we believe an indicator of potential impairment exists, we test to determine whether the impairment recognition criteria in SFAS No. 144

have been met. In evaluating long-lived assets for potential impairment, we will make several significant estimates and judgments, including:

- determining the appropriate grouping of assets at the lowest level for which cash flows are available;
- estimating future cash flows associated with the asset or group of assets; and
- determining an appropriate discount rate to use in the analysis.

If different estimates and judgments are used, the amount and timing of impairments could be affected.

New Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board, or FASB, issued SFAS No. 141 (Revised 2007), "*Business Combinations*", or SFAS No. 141R. SFAS No. 141R will significantly change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) valuing noncontrolling interests at fair value at the acquisition date; and (3) expensing restructuring costs associated with an acquired business. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009. We expect SFAS No. 141R will have an impact on our accounting for future business combinations once adopted but the effect is dependent upon the acquisitions that are made in the future.

In February 2007, the FASB issued SFAS No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*", or SFAS No. 159. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We believe that our adoption of SFAS No. 159 will not have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "*Fair Value Measurements*", or SFAS No. 157. SFAS No. 157 defines fair value in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles ("GAAP") and expands disclosures related to the use of fair value measures in financial statements. SFAS No. 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in GAAP. SFAS No. 157 emphasizes that fair value is a market-based measurement and not an entity-specific measurement based on an exchange transaction in which the entity sells an asset or transfers a liability (exit price). SFAS No. 157 establishes a fair value hierarchy from observable market data as the highest level to fair value based on an entity's own fair value assumptions as the lowest level. SFAS No. 157 was to be effective for our financial statements issued in 2008. In February 2008, the FASB issued FASB Statement of Position, or FSP, No. 157-2 "*Partial Deferral of the Effective Date of Statement 157,*" or FSP No. 157-2, which delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financials statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. We have not yet determined the impact that the adoption of SFAS No. 157 will have on our financial position, results of operations or its cash flows.

Subsequent Events

Joint Venture with Cyberkinetics

In February 2008, we entered into a Collaboration Agreement and Operating Agreement with Cyberkinetics to develop and commercialize products for the treatment of peripheral nerve injury and formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture with 50% ownership held by us and 50% ownership held by Cyberkinetics.

Under the terms of the joint venture, we have agreed to fund the initial $2.0 million in product development costs and have agreed to share equally in all costs in excess of the initial $2.0 million. Cyberkinetics has agreed to contribute technology, know-how and intellectual property, primarily relating to their Andara OFS technology, to the joint venture.

We obtained sales and marketing rights and Cyberkinetics obtained commercial manufacturing rights to any products commercialized under the joint venture. Each party will charge the joint venture at cost for all expenses incurred in connection with their respective commercialization activities. Based on the initial ownership of the joint venture, we will equally split profits and losses realized from the joint venture with Cyberkinetics.

Lease Agreement

In February 2008, we amended the Lease Agreement dated October 18, 2000 between Fourth Avenue LLC and us for office and engineering laboratory space. The amendment extends the term of the lease, currently scheduled to expire on March 31, 2009, through March 31, 2013. Base rent for the period April 2009 through March 2013 will be reduced from the current level of $930,000 annually to a range of $675,000 to $765,000 annually.

In connection with the amendment of the lease, the amount of the irrevocable letter of credit required to be maintained by us for the benefit of the lessor will be reduced from $1,430,000 to $400,000. The letter of credit must be secured by a certificate of deposit in an amount equal to 102% of the letter of credit as security.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this annual report on Form 10-K, including under the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and other sections of this annual report, include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including, without limitation, statements regarding our or our management's expectations, hopes, beliefs, intentions or strategies regarding the future. The words "believe," "may," "will," "estimate," "continue," "anticipate," "intend," "expect," "plan" and similar expressions may identify forward-looking statements, but the absence of these words does not mean that a statement is not forward-looking. The forward-looking statements contained in this annual report are based on our current expectations and beliefs concerning future developments and their potential effects on us. There can be no assurance that future developments affecting us will be those that we have anticipated. These forward-looking statements involve a number of risks, uncertainties (some of which are beyond our control) or other assumptions that may cause actual results or performance to be materially different from those expressed or implied by these forward-looking statements. These risks and uncertainties include, but are not limited to, those factors described in the section titled "Risk Factors." Should one or more of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, actual results may vary in material respects from those projected in these forward-looking statements. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required under applicable securities laws.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash, cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses. We consider investments that, when purchased, have a remaining maturity of 90 days or less to be cash equivalents. The primary objectives of our investment strategy are to preserve principal, maintain proper liquidity to meet operating needs, and maximize yields. To minimize our exposure to an adverse shift in interest rates, we invest mainly in cash equivalents and short-term investments with a maturity of 12 months or less and maintain an average maturity of twelve months or less. We do not believe that a notional or hypothetical 10% change in interest rate percentages would have a material impact on the fair value of our investment portfolio or our interest income.

Item 8. Financial Statements and Supplementary Data

The information required by this item may be found on pages F-1 through F-30 of this Form 10-K with the exception of the unaudited quarterly financial information which is presented below:

	Year Ended December 31, 2007				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Revenues	$ 11,757,786	11,475,509	11,290,004	$ 10,098,912	$ 44,622,211
Gross margin	$ 8,663,168	8,407,874	8,241,990	$ 7,247,381	$ 32,560,413
Net loss attributable to common shareholders	$ (1,377,282)	(1,290,991)	(3,570,925)	$ (2,139,276)	$ (8,378,474)
Net loss per common share:					
Basic	$ (0.11)	(0.10)	(0.28)	$ (0.17)	$ (0.66)
Diluted	$ (0.11)	(0.10)	(0.28)	$ (0.17)	$ (0.66)
Weighted average shares used to compute net loss per common share:					
Basic	12,605,431	12,611,880	12,624,465	12,693,209	12,628,310
Diluted	12,605,431	12,611,880	12,624,465	12,693,209	12,628,310

	Year Ended December 31, 2006				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Revenues	$ 11,823,275	$ 13,970,050	$ 15,261,251	$ 14,195,140	$ 55,249,716
Gross margin	$ 8,943,362	$ 10,592,584	$ 11,525,299	$ 10,630,417	$ 41,691,662
Net income (loss) attributable to common shareholders	$ (102,662)	$ 1,233,700	$ 2,104,630	$ 1,032,138	$ 4,267,806
Net income (loss) per common share:					
Basic	$ (0.01)	$ 0.10	$ 0.17	$ 0.08	$ 0.34
Diluted	$ (0.01)	$ 0.09	$ 0.16	$ 0.08	$ 0.33
Weighted average shares used to compute net income (loss) per common share:					
Basic	12,414,479	12,485,205	12,539,709	12,583,825	12,501,742
Diluted	12,414,479	13,137,867	13,095,430	12,926,449	13,097,891

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

There have been no changes in or disagreements with accountants on accounting and financial disclosure matters in the last fiscal year.

Item 9A. Controls and Procedures

(a)

Evaluation of disclosure controls and procedures.

Our management carried out an evaluation, with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of December 31, 2007. Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosures.

Based upon the evaluation described above, our Chief Executive Officer and Chief Financial Officer have concluded that they believe that our disclosure controls and procedures are effective, as of the end of the period covered by this report, in providing reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosures. We continue to review and document our disclosure controls and procedures, including our internal controls over financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

(b)

Management's Report on Internal Control Over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). 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. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2007 based on the criteria in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation under the framework in *Internal Control Integrated Framework* issued by the COSO, our management concluded that our internal control over financial reporting was effective as of December 31, 2007.

Management has excluded EyeTel from our assessment of internal control over financial reporting as of December 31, 2007 because it was acquired by us in a purchase business combination during the year ended December 31, 2007. The total assets and total revenues related to the acquisition of EyeTel represent 4% and 0%, respectively, of the related financial statement amounts as of and for the year ended December 31, 2007.

The effectiveness of our internal control over financial reporting as of December 31, 2007, has been audited by PricewaterhouseCoopers LLP, an independent registered accounting firm, as stated in their report which is included herein.

(c)

Changes in internal control over financial reporting.

There have been no changes to the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The response to this item is contained in our Proxy Statement relating to our 2008 Annual Meeting of Stockholders (the "Proxy Statement") and is incorporated herein by reference.

Item 11. Executive Compensation

The response to this item is incorporated herein by reference from the discussion responsive thereto in the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The response to this item is incorporated herein by reference from the discussion responsive thereto in the Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The response to this item is incorporated herein by reference from the discussion responsive thereto in the Proxy Statement.

Item 14. Principal Accountant Fees and Services

The response to this item is incorporated herein by reference from the discussion responsive thereto in the Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a)

1. *Financial Statements*

The financial statements are listed in the accompanying index to financial statements on page F-1.

2. *Financial Statement Schedule*

The Schedule on page S-1 is filed as part of this report.

3. *Exhibit Index:*

Exhibit Number	Description
2.1	Asset Purchase Agreement by and among NeuroMetrix, Inc., EyeTel Imaging, Inc. and EyeTel Reading Center, LLC, dated as of December 26, 2007 (9)
3.1	Second Amended and Restated By-laws of NeuroMetrix, Inc. (10)
3.2	Third Amended and Restated Certificate of Incorporation of NeuroMetrix, Inc. (10)
3.3	Certificate of Designations for Series A Junior Cumulative Preferred Stock, par value $0.001 per share (7)
3.4	Amendment No. 1 to Second Amended and Restated Bylaws of NeuroMetrix, Inc. (8)
4.1	Specimen certificate for shares of common stock (1)
4.2	Shareholder Rights Agreement, dated as of March 7, 2007, between NeuroMetrix, Inc. and American Stock Transfer & Trust Company, as Rights Agent (7)
10.1	Lease Agreement dated October 18, 2000 between Fourth Avenue LLC and NeuroMetrix, Inc. (1)
10.2	Amended and Restated 1996 Stock Option/Restricted Stock Plan (1)
10.3	Amended and Restated 1998 Equity Incentive Plan (1)
10.4	First Amendment to Amended and Restated 1998 Equity Incentive Plan (1)
10.5	Amended and Restated 2004 Stock Option and Incentive Plan (2)
10.6	2004 Employee Stock Purchase Plan (1)
10.7	Form of Indemnification Agreement between NeuroMetrix, Inc. and each of its directors (1)
10.8	Employment Agreement, dated June 21, 2004, by and between NeuroMetrix, Inc. and Shai N. Gozani, M.D., Ph.D. (1)
10.9	Letter Agreement, dated June 19, 2002, by and between NeuroMetrix, Inc. and Gary L. Gregory (1)
10.10	NeuroMetrix, Inc. Stock Option Agreements (1998 Plan) dated as of July 1, 2002 and April 8, 2004 by and between NeuroMetrix, Inc. and Gary L. Gregory (1)
10.11	NeuroMetrix, Inc. Confidentiality and Non-Compete Agreement, dated as of June 28, 2002, by and between Gary L. Gregory and NeuroMetrix, Inc. (1)
10.12	NeuroMetrix, Inc. Confidentiality & Non-Compete Agreement dated as of June 21, 2004, by and between Shai N. Gozani, M.D., Ph.D. and NeuroMetrix, Inc. (1)
10.13	NeuroMetrix, Inc. Non-Statutory Stock Option Agreement (1998 Plan) dated as of June 21, 2004, by and between Shai N. Gozani M.D., Ph.D., and NeuroMetrix, Inc. (1)
10.14	Second Amendment to Amended and Restated 1998 Equity Incentive Plan (1)
10.15	NeuroMetrix, Inc. Non-Statutory Stock Option Agreement (1998 Plan) dated as of June 21, 2004 by and between Gary Gregory and NeuroMetrix, Inc. (1)
10.16	Indemnification Agreement dated June 21, 2004, by and between Shai N. Gozani, M.D., Ph.D., and NeuroMetrix, Inc. (1)
10.17	NeuroMetrix, Inc. Confidentiality & Non-Compete Agreement, dated as of May 1, 2000, by and between Michael Williams and NeuroMetrix, Inc. (1)

10.18	NeuroMetrix, Inc. Confidentiality & Non-Compete Agreement, dated as of October 13, 1998, by and between Guy Daniello and NeuroMetrix Inc. (1)
10.19	Form of Incentive Stock Option Agreement, under the NeuroMetrix, Inc. 2004 Stock Option And Incentive Plan (3)
10.20	Form of Non-Qualified Stock Option Agreement For Company Employees, under the NeuroMetrix, Inc. 2004 Stock Option And Incentive Plan (3)
10.21	Form of Non-Qualified Stock Option Agreement For Non-Employee Directors, under the NeuroMetrix, Inc. 2004 Stock Option And Incentive Plan (3)
10.22	Letter Agreement, dated February 7, 2005, by and between NeuroMetrix, Inc. and W. Bradford Smith (4)
10.23	Form of Incentive Stock Option Agreement, under the NeuroMetrix, Inc. 2004 Stock Option and Incentive Plan, by and between NeuroMetrix, Inc. and W. Bradford Smith (4)
10.24	NeuroMetrix, Inc. Confidentiality & Non-Compete Agreement, dated as of February 7, 2005, by and between W. Bradford Smith and NeuroMetrix, Inc. (4)
10.25	Director Compensation Arrangements (5)
10.26	Manufacturing and Supply Agreement, dated as of August 2, 2006, by and between Parlex Polymer Flexible Circuits, Inc. and NeuroMetrix, Inc. (6)
*23.1	Consent of PricewaterhouseCoopers LLP
*31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*32	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*
Filed herewith.

Portions of this exhibit have been omitted pursuant to a request for confidential treatment.

(1)
Incorporated herein by reference to NeuroMetrix, Inc.'s Registration Statement on Form S-1 (Registration No. 333-115440).

(2)
Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on May 26, 2006 (File No. 000-50856).

(3)
Incorporated herein by reference to NeuroMetrix, Inc.'s Quarterly Report on Form 10-Q filed on November 15, 2004 (File No. 000-50856).

(4)
Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on February 11, 2005 (File No. 000-50856).

(5)
Incorporated herein by reference to NeuroMetrix, Inc.'s Annual Report on Form 10-K filed on March 16, 2006 (File No. 000-50856).

(6)
Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on August 2, 2006 (File No. 000-50856).

(7)
Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on March 8, 2007 (File No. 000-50856).

(8)
Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on September 17, 2007 (File No. 000-50856).

(9) Incorporated herein by reference to NeuroMetrix, Inc.'s Current Report on Form 8-K filed on December 28, 2007 (File No. 000-50586).

(10) Incorporated herein by reference to NeuroMetrix, Inc.'s Registration Statement on Form S-8 (Registration No. 333-118059).

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.

NEUROMETRIX, INC.

By: /s/ SHAI N. GOZANI, M.D. PH.D.

Shai N. Gozani, M.D. Ph.D.
Chairman, President and Chief Executive Officer

Date: March 14, 2008

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 on March 14, 2008 in the capacities indicated below.

Name	Title	Date
/s/ SHAI N. GOZANI, M.D., PH. D. Shai N. Gozani, M.D., Ph. D.	Chairman, President and Chief Executive Officer (Principal Executive Officer)	
/s/ W. BRADFORD SMITH W. Bradford Smith	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	
/s/ DAVID E. GOODMAN, M.D. David E. Goodman, M.D.	Director	
/s/ ALLEN J. HINKLE, M.D. Allen J. Hinkle, M.D.	Director	
/s/ CHARLES R. LAMANTIA Charles R. LaMantia	Director	
/s/ W. MARK LORTZ W. Mark Lortz	Director	

82

INDEX TO FINANCIAL STATEMENTS

NeuroMetrix, Inc.

Years ended December 31, 2007, 2006 and 2005

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of NeuroMetrix, Inc.:

In our opinion, the accompanying balance sheets and the related statements of operations, statements of changes in stockholders' equity, and statements of cash flows present fairly, in all material respects, the financial position of NeuroMetrix, Inc. at December 31, 2007 and December 31, 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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 these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 2 to the financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) 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.

As described in Management's Report on Internal Control over Financial Reporting, management has excluded EyeTel Imaging, Inc. from its assessment of internal control over financial reporting as of December 31, 2007 because it was acquired by the Company in a purchase business combination during the year ended December 31, 2007. We have also excluded EyeTel Imaging, Inc. from our audit of internal control over financial reporting. Total assets and total revenues related to the acquisition of EyeTel Imaging, Inc. represent 4.0% and 0.0%, respectively, of the related financial statement amounts as of and for the year ended December 31, 2007.

/s/ PricewaterhouseCoopers LLP

Boston, Massachusetts
March 14, 2008

NeuroMetrix, Inc.

Balance Sheets

	December 31, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 7,097,239	$ 7,909,778
Short-term held-to-maturity investments	22,621,741	32,410,685
Restricted cash	45,000	
Accounts receivable, net of allowance for doubtful accounts of $906,000 and $900,000 at December 31, 2007 and 2006, respectively	5,731,697	7,698,550
Inventories	5,354,338	3,633,389
Prepaid expenses and other current assets	710,159	761,400
Current portion of deferred costs	464,061	370,013
Total current assets	42,024,235	52,783,815
Restricted cash	1,458,598	1,458,598
Fixed assets, net	2,973,718	1,115,436
Long-term available-for-sale investment	1,058,255	
Goodwill	5,833,464	
Other intangible assets	2,800,000	
Deferred costs	226,304	348,430
Total assets	$ 56,374,574	$ 55,706,279
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,627,889	$ 2,766,650
Accrued compensation	2,127,546	2,460,328
Accrued expenses	2,308,563	4,275,983
Current portion of deferred revenue	1,643,026	1,386,867
Current portion of capital lease obligation	12,900	
Total current liabilities	8,719,924	10,889,828
Deferred revenue	891,958	1,335,138
Capital lease obligation net of current portion	18,275	
Other long-term liabilities	14,546	72,727
Total liabilities	9,644,703	12,297,693
Commitments and contingencies (Note 9)		
Stockholders' equity		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, none outstanding		
Common stock, $0.0001 par value; 50,000,000 authorized; 13,690,134 and 12,601,224 shares issued and outstanding at December 31, 2007 and 2006, respectively	1,369	1,260
Additional paid-in capital	110,235,835	97,205,145
Deferred compensation		(110,705)
Accumulated deficit	(62,065,588)	(53,687,114)
Accumulated other comprehensive loss	(1,441,745)	
Total stockholders' equity	46,729,871	43,408,586
Total liabilities and stockholders' equity	$ 56,374,574	$ 55,706,279

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

NeuroMetrix, Inc.

Statements of Operations

	Years Ended December 31,		
	2007	2006	2005
Revenues:			
Diagnostic device	$ 4,254,011	$ 7,538,320	$ 4,221,311
Biosensor	39,413,265	47,711,396	30,076,822
Other	954,935		
Total revenues	44,622,211	55,249,716	34,298,133
Cost of revenues	12,061,798	13,558,054	8,858,094
Gross margin	32,560,413	41,691,662	25,440,039
Operating expenses:			
Research and development	4,891,937	5,010,513	3,820,624
Sales and marketing	22,963,840	22,013,682	14,150,157
General and administrative	14,834,073	11,805,062	8,021,783
Total operating expenses	42,689,850	38,829,257	25,992,564
Income (loss) from operations	(10,129,437)	2,862,405	(552,525)
Interest income	1,750,963	1,598,401	838,825
Interest expense			(2,042)
Income (loss) before provision for income taxes	(8,378,474)	4,460,806	284,258
Provision for income taxes		193,000	35,000
Net income (loss)	$ (8,378,474)	$ 4,267,806	$ 249,258
Net income (loss) per common share:			
Basic	$ (0.66)	$ 0.34	$ 0.02
Diluted	$ (0.66)	$ 0.33	$ 0.02
Weighted average shares used to compute net income (loss) per common share:			
Basic	12,628,310	12,501,742	12,152,139
Diluted	12,628,310	13,097,891	12,986,365
Comprehensive income (loss):			
Net income (loss)	$ (8,378,474)	$ 4,267,806	$ 249,258
Unrealized loss on available-for-sale investment	(1,441,745)		
Comprehensive income (loss)	$ (9,820,219)	$ 4,267,806	$ 249,258

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

NeuroMetrix, Inc.

Statements of Changes in Stockholders' Equity

	Common Stock						
	Number of Shares	Amount	Additional Paid-In Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2004	12,034,650	$ 1,203	$ 92,278,379	$ (745,086)	$ (58,204,178)	$	33,330,318
Issuance of stock upon exercise of stock options and warrants	317,361	32	512,825				512,857
Compensation expense associated with stock options			120,272				120,272
Adjustment to deferred compensation associated with terminated employees			(33,405)	33,405			
Amortization of deferred compensation				286,058			286,058
Issuance of common stock under employee stock purchase plan	23,265	3	299,297				299,300
Income tax effect of the exercise of stock options			35,000				35,000
Net income					249,258		249,258
Balance at December 31, 2005	12,375,276	1,238	93,212,368	(425,623)	(57,954,920)		34,833,063
Issuance of stock upon exercise of stock options	202,808	20	1,180,637				1,180,657
Stock-based compensation expense			2,403,222				2,403,222
Adjustment to deferred compensation associated with terminated employees			(65,503)	65,503			
Amortization of deferred compensation				249,415			249,415
Issuance of common stock under employee stock purchase plan	23,140	2	394,621				394,623
Income tax effect of the exercise of stock options			79,800				79,800
Net income					4,267,806		4,267,806
Balance at December 31, 2006	12,601,224	1,260	97,205,145	(110,705)	(53,687,114)		43,408,586
Issuance of stock upon exercise of stock options	5,957	1	24,099				24,100
Stock-based compensation expense			2,976,059				2,976,059
Adjustment to deferred compensation associated with terminated employees			(15,674)	15,674			
Amortization of deferred compensation				95,031			95,031
Issuance of common stock under employee stock purchase plan	32,656	3	261,763				261,766
Issuance of common stock to complete the acquisition of EyeTel	1,050,297	105	9,784,443				9,784,548
Unrealized loss on long-term investment						(1,441,745)	(1,441,745)
Net loss					(8,378,474)		(8,378,474)

	Common Stock						
Balance at December 31, 2007	13,690,134	$ 1,369	$ 110,235,835	$	$ (62,065,588)	$ (1,441,745)	$ 46,729,871

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

F-6

NeuroMetrix, Inc.

Statements of Cash Flows

	Years Ended December 31,		
	2007	2006	2005
Cash flows for operating activities:			
Net income (loss)	$ (8,378,474)	$ 4,267,806	$ 249,258
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	422,938	380,655	278,932
Compensation expense associated with stock options	3,071,090	2,652,637	406,330
Provision for doubtful accounts	358,141	946,850	281,684
Amortization of premium on investments	(41,811)	184,163	439,734
Income tax effect of the exercise of stock options		79,800	35,000
Changes in operating assets and liabilities, net of effect of acquisition:			
Accounts receivable	1,643,712	(4,102,061)	(1,698,458)
Inventories	(1,720,949)	(949,980)	(1,399,148)
Prepaid expenses and other current assets	267,241	(147,231)	58,801
Accounts payable	(7,340)	1,068,067	799,292
Accrued expenses and compensation	(3,386,539)	2,147,762	1,925,923
Other long-term liabilities	(58,181)	(58,182)	(58,182)
Deferred revenue and deferred costs	(158,943)	827,617	588,924
Net cash provided by (used in) operating activities	(7,989,115)	7,297,903	1,908,090
Cash flows for investing activities:			
Purchases of fixed assets	(257,520)	(620,540)	(475,124)
Purchases of investments	(27,959,957)	(42,141,626)	(15,290,120)
Maturities of investments	37,790,712	33,628,724	18,840,191
Purchase of Cyberkinetics common stock	(2,500,000)		
Acquisition of EyeTel	(175,000)		
Release of restricted cash			438,602
Net cash provided by (used in) investing activities	6,898,235	(9,133,442)	3,513,549
Cash flows from financing activities:			
Proceeds from exercise of stock options	24,100	1,180,657	512,857
Proceeds from issuance of common stock under employee stock purchase plan	261,766	394,623	299,300
Payments on long-term debt	(7,525)		
Net cash provided by financing activities	278,341	1,575,280	812,157
Net increase (decrease) in cash and cash equivalents	(812,539)	(260,259)	6,233,796
Cash and cash equivalents, beginning of year	7,909,778	8,170,037	1,936,241
Cash and cash equivalents, end of year	$ 7,097,239	$ 7,909,778	$ 8,170,037
Supplemental disclosure of cash flow information:			
Equipment acquired under capital lease	$ 38,700	$	$
Fair value of EyeTel assets acquired	10,914,464		
Fair value of common stock issued to EyeTel	9,784,548		
EyeTel liabilities assumed	804,916		

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

F-7

NeuroMetrix, Inc.

Notes to Financial Statements

1. Business and Summary of Significant Accounting Policies

Business

NeuroMetrix, Inc. (the "Company"), a Delaware corporation, was founded in June 1996. The Company designs, develops and markets proprietary medical devices used to help physicians diagnose and treat diseases of the nervous system such as neuropathies, which are disorders of the peripheral nerves and parts of the spine, and neurovascular disorders such as diabetic retinopathy. The Company also develops medical devices designed to be used to provide regional anesthesia and pain control. Our focus to date has been on products that help physicians with the diagnosis of neuropathies and neurovascular disorders. We have two products lines cleared by the United States Food and Drug Administration ("FDA") that are currently being marketed to physicians, including the NC-stat System and the DigiScope.

In November 2007, the Company made an investment of $2.5 million for the purchase of approximately 5.4 million shares of common stock of Cyberkinetics Neurotechnology Systems, Inc. ("Cyberkinetics"), representing approximately 13% of Cyberkinetics' issued and outstanding shares at the time of the investment, at a price of $0.46 per share. The Company also received a warrant to purchase up to approximately 2.7 million shares of Cyberkinetics common stock. The warrant is exercisable at $0.46 per share and has a term of five years, but will be required to be exercised if Cyberkinetics receives FDA approval of a Humanitarian Device Exemption ("HDE") filing for the Andara OFS (Oscillating Frequency Stimulation) ("Andara OFS") device for acute spinal cord injuries.

On December 26, 2007, the Company acquired substantially all of the assets of EyeTel Imaging, Inc., ("EyeTel") for an aggregate purchase price of 1,050,297 shares of the Company's common stock, $175,000 in cash and the assumption of certain specified liabilities totaling $804,916. EyeTel was engaged in the design, development, and commercialization of proprietary medical devices, including the DigiScope, a device that helps physicians detect eye disorders such as diabetic retinopathy, the leading cause of blindness in patients with diabetes. The DigiScope, developed in collaboration with the Wilmer Eye Institute at Johns Hopkins University, is an FDA cleared diagnostic device that primary care physicians and endocrinologists can use for the early detection of diabetic retinopathy. The Company had previously entered into an exclusive licensing agreement with EyeTel pursuant to which the Company had sales and marketing rights to the DigiScope in the primary diabetes care physician market. The acquisition is intended to further diversify the Company's proprietary medical device product offering and expand sales into additional markets such as the optometry market. The Company's balance sheet at December 31, 2007, includes the acquired assets and assumed liabilities of EyeTel (Note 3). There was no material impact to the Company's statement of operations for the year ended December 31, 2007 subsequent to the acquisition.

Significant Accounting Policies

Significant accounting policies applied by the Company in the preparation of its financial statements are as follows:

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity of ninety days or less to be cash equivalents. Cash equivalents are recorded at cost which approximates fair value. The

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

Company invests cash primarily in a money market account and other investments which management believes are subject to minimal credit and market risk.

Held-to-Maturity Investments

The Company's investment portfolio is classified as held-to-maturity, and such investments are stated at amortized cost. Interest earned on investments held-to-maturity is included in interest income. The amortized cost of investments held-to-maturity is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in interest income.

Long-Term Available-for-Sale Investment

In accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 115, "*Accounting for Certain Investments in Debt and Equity Securities*", ("SFAS No. 115"), the Company's investment in Cyberkinetics is classified as available-for-sale and is carried at fair value, with any unrealized gains and losses, net of taxes, reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity.

Restricted Cash

At December 31, 2007, the Company held short-term restricted cash in the amount of $45,000 in connection with certain liabilities assumed with the acquisition of EyeTel on December 26, 2007. The Company maintained long-term restricted cash in the amount of $1,458,598 at December 31, 2007 and 2006, respectively, associated with a facility lease. See Note 9 Commitments and Contingencies and Note 11 Subsequent Events.

Concentration of Credit Risk

Financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents in bank deposit accounts, short-term investments, long-term investments and trade receivables. The Company invests its funds in highly rated institutions and limits its investment in any individual debtor. The Company has not experienced significant losses related to cash and cash equivalents or short-term investments and does not believe it is exposed to any significant credit risks relating to its cash and cash equivalents and short-term investments.

The Company distributes its products through its own regional sales managers, who had managed independent sales agencies through the end of 2007. At December 31, 2007 and 2006 and for the years ended December 31, 2007, 2006 and 2005, no single customer accounted for more than 10% of accounts receivable or revenue.

The Company relies on two third-party manufacturers to manufacture all of its current products. The disruption or termination of the supply of these products or a significant increase in the cost of these products from these sources could have an adverse effect on the Company's business, financial position and results of operations.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

Inventories

Inventories, consisting primarily of purchased components, are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. The Company writes down inventory to its net realizable value for excess or obsolete inventory.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, short-term investments, long-term investments, accounts receivable, accounts payable and accrued expenses, approximate their fair value at December 31, 2007 and 2006.

Revenue Recognition

The Company recognizes revenue when the following criteria have been met: persuasive evidence of an arrangement exists, delivery has occurred and risk of loss has passed, the seller's price to the buyer is fixed or determinable and collection is reasonably assured. The Company recorded revenue on a net basis for product sales made to independent sales agencies or distributors, based upon the amount billed to the distributors, when the distributor accepts the responsibility for invoicing the customer and the responsibility for the risk of collections and product returns from the customer. During 2007, the Company terminated its relationships with all independent sales agencies and focused selling efforts exclusively through the direct sales force.

When multiple elements are contained in a single arrangement, the Company allocates revenue between the elements based on their relative fair value, provided that each element meets the criteria for treatment as a separate unit of accounting. An element is considered a separate unit of accounting if it has value to the customer on a stand-alone basis, there is objective, reliable evidence of the fair value of the undelivered elements and delivery or performance of the undelivered elements is considered probable and substantially in the control of the Company. Fair value is determined based upon the price charged when the element is sold separately.

Diagnostic device revenues consist of sales of NC-stat monitors and NC-stat docking stations. Revenues associated with the sale of the NC-stat monitors are recognized upon shipment provided that the fee is fixed or determinable, evidence of a persuasive arrangement exists, collection of receivables is reasonably assured, product returns are reasonably estimable and no continuing obligations exist. The revenues from the sale of a NC-stat docking station and access to the onCall Information System are considered one unit of accounting and deferred and recognized on a straight line basis over the estimated period of time the Company provides the service associated with the onCall Information System, which is the shorter of the estimated customer relationship period or the estimated useful life of the docking station, currently three years. The resulting deferred revenue and deferred costs are presented as separate line items on the accompanying balance sheet.

Biosensor revenues consist of sales of disposable NC-stat biosensors and are recognized upon shipment provided that the fee is fixed or determinable, persuasive evidence of an arrangement exists, collection of receivables is reasonably assured and product returns are reasonably estimable.

The Company recognizes revenues associated with installation and training services related to NC-stat Systems sales upon completion of the service. The fair value of the installation and training is based on hourly service billing rates.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

Certain product sales are made with a 30-day right of return. Since the Company can reasonably estimate future returns, the Company recognizes revenues associated with product sales that contain a right of return upon shipment and at the same time reduces revenue by the amount of estimated returns under the provisions of SFAS No. 48, "*Revenue Recognition When Right of Return Exists*".

Other revenues consist entirely of revenues relating to the DigiScope sold under a license agreement with EyeTel. Revenue was recognized on a gross basis and comprised of installation and training fees, per patient fees for eye scans performed using the DigiScope and monthly rental fees for the use of the DigiScope. Installation and training fees are deferred and recognized on a straight line basis over the non-cancelable term of the customer contract, currently one year. Revenues from fees charged for patient eye scans are recognized as the scans are performed. Fees for the rental of the DigiScope are recognized on a monthly basis. Under the terms of the exclusive sales and marketing license to the DigiScope from EyeTel, amounts due to EyeTel were recorded as cost of revenues.

Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in its existing accounts receivable. The Company reviews its allowance for doubtful accounts and determines the allowance based on an analysis of customer past payment history, product usage activity, and recent communications between the Company and the customer. Past due balances over 90 days are reviewed individually for collectibility. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have any off-balance sheet credit exposure related to its customers.

Income Taxes

The Company records income taxes using the asset and liability method. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and operating loss and tax credit carryforwards. The Company's financial statements contain certain deferred tax assets, which have arisen primarily as a result of operating losses, as well as other temporary differences between financial and tax accounting. SFAS No. 109 "*Accounting for Income Taxes*," requires the Company to establish a valuation allowance if the likelihood of realization of the deferred tax assets is reduced based on an evaluation of objective verifiable evidence. Significant management judgment is required in determining the Company's provision for income taxes, the Company's deferred tax assets and liabilities and any valuation allowance recorded against those net deferred tax assets. The Company evaluates the weight of all available evidence to determine whether it is more likely than not that some portion or all of the net deferred income tax assets will not be realized.

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes an interpretation of SFAS No. 109*" ("FIN 48"). FIN 48 requires management to perform a two-step evaluation of all tax positions, ensuring that these tax return positions meet the "more-likely than not" recognition threshold and can be measured with sufficient precision to determine the benefit recognized in the financial statements. These evaluations provide management with a comprehensive model for how a company should recognize, measure,

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

present, and disclose in its financial statements certain tax positions that the Company has taken or expects to take on income tax returns. Management estimated that as of December 31, 2006, there was an uncertain tax position totaling approximately $100,000 relating to the Company's tax credit carryforwards. As a result, the Company reduced its deferred tax assets and the associated valuation allowance by approximately $100,000 as of January 1, 2007, the adoption date of FIN 48. There have been no other activities impacting FIN 48 reserves during the year ended December 31, 2007.

Research and Development

Costs incurred in the research and development of the Company's products are expensed as incurred. Included in research and development costs are wages, benefits, product design consulting and other operating costs such as facilities, supplies and overhead directly related to the Company's research and development efforts.

Product Warranty Costs

The Company accrues estimated product warranty costs at the time of sale which are included in cost of revenues in the statements of operations. The amount of the accrued warranty liability is based on historical information such as past experience, product failure rates, number of units repaired and estimated cost of material and labor.

The following is a rollforward of the Company's accrued warranty liability for the years ended December 31, 2007, 2006 and 2005:

	Years Ended December 31,		
	2007	**2006**	**2005**
Balance at beginning of period	$ 231,725	$ 124,852	$ 116,779
Accrual for warranties	749,078	688,234	314,117
Settlements made	(728,855)	(581,361)	(306,044)
Balance at end of period	$ 251,948	$ 231,725	$ 124,852

Fixed Assets and Long-Lived Assets

Fixed assets are recorded at cost and depreciated using the straight-line method over the estimated useful life of each asset. Expenditures for repairs and maintenance are charged to expense as incurred. On disposal, the related assets and accumulated depreciation are eliminated from the accounts and any resulting gain or loss is included in the Company's statement of operations. Leasehold improvements are amortized over the shorter of the estimated useful life of the improvement or the remaining term of the lease.

The Company periodically evaluates the recoverability of its fixed assets and other long-lived assets, including intangibles, when circumstances indicate that an event of impairment may have occurred in accordance with the provisions of SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*". This periodic review may result in an adjustment of estimated depreciable lives or an asset impairment. When indicators of impairment are present, the carrying values of the asset are evaluated in relation to the assets operating performance and future undiscounted cash flows of the underlying assets. If the future undiscounted cash flows are less than their book value, an impairment

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

exists. The impairment is measured as the difference between the book value and the fair value of the underlying asset. Fair values are based on estimates of the market prices and assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. No impairments were identified in the years ended December 31, 2007, 2006 and 2005.

Goodwill and Other Intangible Assets

As result of the acquisition of substantially all of the assets of EyeTel on December 26, 2007, the Company identified approximately $5.8 million of goodwill and $2.8 million of other intangible assets on its balance sheet at December 31, 2007. The Company will amortize intangible assets using the straight-line method over their estimated economic lives, which is estimated to be 5 years, or using the economic use method if that method results in significantly greater amortization than the straight-line method. Determining the economic lives of acquired intangible assets requires us to make significant judgment and estimates, and can materially impact the Company's operating results.

In accordance with the provisions of SFAS No. 142, "*Goodwill and Other Intangible Assets*" ("SFAS No. 142") , the Company will assess the realizability of goodwill annually, as well as whenever events or changes in circumstances suggest that the carrying amount may not be recoverable. The Company's ability to realize the value of the goodwill will depend on the future cash flows of the business. If the Company is not able to realize the value of goodwill, the Company may be required to incur material charges relating to the impairment of goodwill.

Accounting for Stock-Based Compensation

In December 2004, the FASB issued SFAS No. 123(R), "*Share Based Payment*" ("SFAS No. 123(R)"), which requires that the expense resulting from all share-based payment transactions be recognized in the financial statements. SFAS No. 123(R) revises SFAS No. 123 "*Accounting for Stock-Based Compensation*" ("SFAS No. 123") and supersedes Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*" ("APB No. 25") and SFAS No. 148, "*Accounting for Stock Based Compensation Transition and Disclosure an amendment of Financial Accounting Standards Board Statement No. 123*" ("SFAS No. 148".) As a result, beginning January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective method and has begun reflecting the stock-based compensation expense determined under fair value based methods in the statement of operations rather than as pro forma disclosure in the notes to the financial statements. Under this transition method, the compensation cost recognized beginning January 1, 2006 includes compensation cost for (i) all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123, and (ii) all share based payments granted or modified subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost is generally recognized ratably over the requisite service period. Prior period amounts have not been restated. The Company uses the Black-Scholes option pricing model for determining the fair value of its stock options and amortizes its stock-based compensation expense using the straight-line method.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

Prior to the adoption of SFAS No. 123(R), the Company accounted for stock options granted to employees in accordance with APB No. 25 and provided the disclosures required under SFAS No. 148 only in the notes to our financial statements. Accordingly, compensation expense was recorded for options issued to employees to the extent that the fair market value of the Company's common stock exceeded the exercise price of the option at the date granted and all other criteria for fixed accounting were met. All stock-based awards granted to non-employees were accounted for at their fair value and the resulting compensation expense was generally recognized over the period of service.

Net Income (Loss) Per Common Share

The Company accounts for and discloses net income (loss) per common share in accordance with SFAS No. 128, "*Earnings Per Share*". Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding. Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares and dilutive potential common share equivalents then outstanding. Potential common shares consist of shares issuable upon the exercise of stock options and warrants (using the treasury stock method.)

	Years Ended December 31,		
	2007	2006	2005
Basic:			
Net income (loss)	$ (8,378,474)	$ 4,267,806	$ 249,258
Weighted average shares	12,628,310	12,501,742	12,152,139
Basic income (loss) per common share	$ (0.66)	$ 0.34	$ 0.02
Diluted:			
Net income (loss)	$ (8,378,474)	$ 4,267,806	$ 249,258
Weighted average shares	12,628,310	12,501,742	12,152,139
Effect of stock options		596,149	821,254
Effect of warrants			12,972
Weighted average shares, as adjusted	12,628,310	13,097,891	12,986,365
Diluted income (loss) per common share	$ (0.66)	$ 0.33	$ 0.02

The following potentially dilutive common shares were excluded from the calculation of diluted net income (loss) per common share because their effect was antidilutive for each of the periods presented:

	Years Ended December 31,		
	2007	2006	2005
Options	1,661,427	366,618	45,400

Advertising and Promotional Costs

Advertising and promotional costs are expensed as incurred. Advertising and promotion expense was $718,650, $547,441 and $280,034 in the years ended December 31, 2007, 2006 and 2005, respectively.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

Accumulated Other Comprehensive Loss

SFAS No. 130, "*Reporting Comprehensive Income*" establishes standards for reporting and displaying comprehensive income and its components in a full set of general-purpose financial statements. In November 2007, the Company entered into a strategic alliance with Cyberkinetics, a medical device company focused on neurological conditions. The Company made an investment of $2.5 million in shares of Cyberkinetics common stock and is accounting for this investment as an available-for-sale security under the provisions of SFAS No. 115. Accordingly, at December 31, 2007, the Company has recorded the decrease in fair value of this investment within other comprehensive loss. For the years ended December 31, 2006 and 2005, the Company had no components of other comprehensive income or loss other than net income (loss).

Segments

The Company is in the business of designing, developing and selling proprietary medical devices. The Company evaluates its business activities that are regularly reviewed by the Chief Executive Officer for which discrete financial information is available. As a result of this evaluation, the Company determined that it has one operating segment with operations in two geographical locations which are in the United States.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Risks and Uncertainties

The Company is subject to risks common to companies in the medical device industry, including, but not limited to, development by the Company or its competitors of new technological innovations, dependence on key personnel, customers' reimbursement from third-party payers, protection of proprietary technology, and compliance with regulations of the FDA and other governmental agencies.

Reclassification

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

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R will significantly change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) valuing noncontrolling interests at fair value at the acquisition date; and (3) expensing restructuring costs associated with an acquired business. SFAS

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

1. Business and Summary of Significant Accounting Policies (Continued)

No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The Company expects SFAS No. 141R will have an impact on accounting for future business combinations once adopted but the effect is dependent upon if any acquisitions are made in the future.

In February 2007, the FASB issued SFAS No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*." ("SFAS No. 159") SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company does not believe that the adoption of SFAS No. 159 will have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "*Fair Value Measurements*" ("SFAS No. 157"). SFAS No. 157 defines fair value in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles ("GAAP") and expands disclosures related to the use of fair value measures in financial statements. SFAS No. 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in GAAP. SFAS No. 157 emphasizes that fair value is a market-based measurement and not an entity-specific measurement based on an exchange transaction in which the entity sells an asset or transfers a liability (exit price). SFAS No. 157 establishes a fair value hierarchy from observable market data as the highest level to fair value based on an entity's own fair value assumptions as the lowest level. SFAS No. 157 was to be effective for our financial statements issued in 2008. In February 2008, the FASB issued FASB Statement of Position, ("FSP") No. 157-2 "*Partial Deferral of the Effective Date of Statement 157,*" ("FSP No. 157-2"), which delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financials statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The Company has not yet determined the impact that the adoption of SFAS No. 157 will have on its financial position, results of operations or its cash flows.

2. Stock Option Plans, Stock-Based Compensation and Common Stock

Stock Option Plans

During 1996, the Company adopted the 1996 Stock Option/Restricted Stock Plan (the "1996 Stock Plan"). The 1996 Stock Plan provides for the granting of incentive and non-qualified stock options and stock bonus awards to officers, directors and employees of the Company. The maximum number of shares that may be issued pursuant to the 1996 Stock Plan is 156,250. All of the outstanding options under the 1996 Stock Plan are fully vested and terminate 10 years after the grant date, or earlier if the option holder is no longer an executive officer, employee, consultant, advisor or director, as applicable, of the Company. As of December 31, 2006, all shares had been issued under the 1996 Stock Plan.

During 1998, the Company adopted the 1998 Equity Incentive Plan (the "1998 Stock Plan"). The 1998 Stock Plan also provides for granting of incentive and nonqualified stock option and stock bonus awards to officers, employees and outside consultants. Outstanding options under the 1998 Stock Plan generally vest over three or four years and terminate 10 years after the grant date, or earlier if the

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

2. Stock Option Plans, Stock-Based Compensation and Common Stock (Continued)

option holder is no longer an executive officer, employee, consultant, advisor or director, as applicable, of the Company. As of December 31, 2007, 1,250,000 shares of common stock were authorized for issuance under the 1998 Stock Plan, of which 546,731 shares had been issued and 607,739 shares were subject to outstanding options at a weighted average exercise price of $7.17 per share. The 1998 Stock Plan was closed to any future grants at the time of the Company's Initial Public Offering ("IPO") and therefore the Company will not make any additional grants under the 1998 Stock Plan.

During 2004, the Company adopted the 2004 Stock Option and Incentive Plan, as amended and restated in 2006 (the "2004 Stock Plan"). The 2004 Stock Plan also provides for granting of incentive and nonqualified stock option and stock bonus awards to officers, employees and outside consultants. Outstanding options under the 2004 Stock Plan generally vest over three or four years and terminate 10 years after the grant date, or earlier if the option holder is no longer an executive officer, employee, consultant, advisor or director, as applicable, of the Company. As of December 31, 2007, 1,946,022 shares of common stock were authorized for issuance under the 2004 Stock Plan, of which 92,963 shares had been issued, 1,241,153 shares were subject to outstanding options at a weighted average exercise price of $14.25 per share and 611,906 shares were available for future grant. In March 2006, the Company's Board of Directors voted to discontinue the provision of the 2004 Stock Plan which automatically increased the number of options available for grant under the 2004 Stock Plan based on the net increase in the total number of outstanding shares of common stock during the year.

The exercise price of each stock option issued under the 1996 and 1998 Stock Plans was specified by the Board of Directors at the time of grant. The exercise price of stock options awarded under the 2004 Stock Plan may not be less than the fair market value of the common stock on the date of the option grant. For holders of more than 10% of the Company's total combined voting power of all classes of stock, incentive stock options may not be granted at less than 110% of the fair market value of the Company's common stock at the date of grant and for a term not to exceed five years.

Certain stock options granted prior to January 1, 2006 covering a total of 15,480 shares were modified during 2006 to increase the exercise price to the estimated fair market value as of the original date of grant. These stock options were originally issued at a discount to fair market value in the first half of 2004 prior to the Company's IPO. The grants have been revalued using the Black Scholes option pricing model and the sum of the difference between fair value immediately before and after the modifications and the remaining original intrinsic value is being amortized to expense over the remaining vesting period.

In June 2004, the Company adopted the 2004 Employee Stock Purchase Plan ("ESPP"). All of our employees who have been employed by the Company for at least 60 days and whose customary employment is for more than 20 hours per week and for more than five months in any calendar year are eligible to participate and any employee who owns 5% or more of the voting power or value of our stock is not eligible to participate. An employee may purchase no more than $25,000 worth of common stock, valued at the start of the purchase period, in any calendar year. The ESPP authorizes the issuance of up to a total of 375,000 shares of our common stock to participating employees.

Under the ESPP, participating employees can authorize the Company to withhold up to 10% of their earnings during consecutive six-month payment periods for the purchase of the shares. At the conclusion of each period, participating employees can purchase shares at 85% of the lower of their fair market value at the beginning or end of the period. The ESPP is regarded as a compensatory plan according to the provisions of SFAS No. 123(R). Under this plan, the Company has issued 32,656,

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

2. Stock Option Plans, Stock-Based Compensation and Common Stock (Continued)

23,140 and 23,265 shares of its common stock during the years ended December 31, 2007, 2006 and 2005, respectively.

A summary of activity under the Company's 1996, 1998 and 2004 Stock Plans for the year ended December 31, 2007 is presented below:

	Number of Shares	Exercise Price Range	Weighted Average Exercise Price
Stock Option Awards			
Outstanding at December 31, 2006	1,215,094	0.40 38.96	14.66
Granted at fair value	906,700	7.36 14.91	9.62
Exercised	(12,207)	0.40 10.40	2.08
Forfeited	(260,695)	1.35 38.96	17.14
Outstanding at December 31, 2007	1,848,892	$ 0.40 38.96	$ 11.92

The aggregate intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005 was $99,034, $5,304,033 and $6,713,552, respectively.

The following table summarizes information about stock options outstanding at December 31, 2007:

Exercise Price	Number of Options Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$0.40 7.36	93,989	5.3	$ 2.54
$7.52 8.00	528,250	6.6	7.99
$8.13 9.50	223,808	9.1	9.05
$9.52 9.52	514,300	9.2	9.52
$9.61 30.10	405,620	7.9	19.32
$30.26 38.96	82,925	7.8	34.02
	1,848,892	7.9	$ 11.92

The following table summarizes information about stock options exercisable at December 31, 2007:

Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
$0.40 7.36	81,737	$ 2.52
$7.52 8.00	446,812	8.00
$8.13 9.50	43,432	9.17
$9.52 9.52		
$9.61 30.10	153,335	20.28
$30.26 38.96	37,985	34.07
	763,301	$ 11.24

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

2. Stock Option Plans, Stock-Based Compensation and Common Stock (Continued)

The weighted average remaining contractual life for stock options exercisable at December 31, 2007 was 7.9 years. The aggregate intrinsic value for stock options outstanding and exercisable at December 31, 2007 was $1,305,157 and $1,088,300 respectively.

Stock-Based Compensation

Prior to January 1, 2006, the Company accounted for stock-based compensation plans in accordance with the provisions of APB No. 25, as permitted by SFAS No. 123, and accordingly did not recognize compensation expense for the issuance of options with an exercise price equal to or greater than the fair value at the date of grant. The following table illustrates the effect on net income (loss) and net income (loss) per common share for the year ended December 31, 2005 had the Company applied the fair value based method as prescribed by SFAS No. 123:

	2005
Net income attributable to common stockholders, as reported	$ 249,258
Add employee stock-based compensation expense included in reported net income	406,330
Less employee stock-based compensation expense determined under fair value method	(1,432,031)
Net loss pro forma	$ (776,443)
Net income (loss) per common share (basic and diluted):	
As reported	$ 0.02
Pro forma	$ (0.06)

The weighted average grant-date fair value used in the calculation of stock-based compensation expense in the accompanying statement of operations for the years ended December 31, 2007, 2006 and 2005 and the pro forma net income (loss) and net income (loss) per common share information presented above is calculated using the Black-Scholes option pricing model with the following weighted average assumptions:

	Years Ended December 31,		
	2007	2006	2005
Risk-free interest rate	3.3% 5.1%	4.3% 5.2%	3.5% 4.6%
Expected dividend yield			
Expected option term	5 years	5 years	5 years
Volatility	60.0% 70.0%	50.0% 75.0%	52.6%
Weighted average fair value of options granted at fair value	$5.76	$14.76	$7.23
Weighted average fair value of options granted below fair value	$	$	$

The risk-free interest rate assumption is based on the United States Treasury's constant maturity rate for a five year term (corresponding to the expected option term) on the date the option was granted. The expected dividend yield is zero because the Company does not currently pay dividends nor expects to do so during the expected option term. The expected option term of five years is

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

2. Stock Option Plans, Stock-Based Compensation and Common Stock (Continued)

estimated based on an analysis of actual option exercises and a review of comparable medical device companies. The volatility assumption is based on weekly historical volatility during the time period that corresponds to the expected option term, a review of comparable medical device companies and expected future stock price volatility. The pre-vesting forfeiture rate is based on the historical and projected average turnover rate using four classifications of employees.

The Company uses the Black-Scholes option pricing model for determining the fair value of shares of common stock issued or to be issued under the ESPP. The following assumptions are used in determining fair value: The risk-free interest rate assumption is based on the United States Treasury's constant maturity rate for a six month term (corresponding to the expected option term) on the date the option was granted. In 2007 and 2006, the Company used a risk-free interest rate assumption that ranged from 3.5% to 5.1% and 5.1% to 5.2%, respectively. The expected dividend yield is zero because the Company does not currently pay dividends nor expects to do so during the expected option term. An expected term of six months is used based on the duration of each plan offering period. The volatility assumption is based on stock price volatility over the most recent period of time corresponding to the expected term and is also based on expected future stock price volatility. In 2007 and 2006, the expected future stock price volatility ranged from 60.0% to 70.0% and 50.0% to 90.0%, respectively.

The Company recorded stock-based compensation expense of $3,071,090, $2,652,637 and $406,330 for the years ended December 31, 2007, 2006 and 2005, respectively. Included in the stock-based compensation expense recorded by the Company for the years ended December 31, 2007 and 2006 is (a) $2,902,662 and $2,265,556, respectively, in compensation expense relating to stock options granted to employees subsequent to the Company's July 2004 IPO that are accounted for according to the provisions of SFAS No. 123(R); (b) $37,752 and $53,471, respectively, in reductions of compensation expense related to stock options granted to non-employees that are accounted for according to the provisions of Emerging Issues Task Force ("EITF") Issue No. 96-18 "*Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*" ("EITF No. 96-18"); (c) $94,325 and $159,480, respectively, in compensation expense related to the ESPP and accounted for under the provisions of SFAS No. 123(R): (d) $95,031 and $249,415, respectively in compensation expense relating to stock options granted to employees prior to the Company's IPO that are being accounted for using the intrinsic value method according to the provisions of SFAS No. 123(R) and (e) $16,824 and $31,657, respectively in compensation expense related to modifications to pre-IPO option grants. Compensation expense recorded by the Company for the modification of stock options for the year ended December 31, 2005 was $35,790.

The additional costs incurred as a result of the implementation of SFAS No. 123(R) reflected in income before provision of income taxes and net income attributable to common stockholders for the years ended December 31, 2007 and 2006 was $2,996,987 and $2,425,036, respectively. The effect on basic and diluted earnings per share for the years ended December 31, 2007 and 2006 was $0.24 and $0.19, respectively.

Stock options granted to non-employees are recorded at fair value and adjusted to market over the vesting period according to the provisions of EITF No. 96-18. The Company determines fair value using the Black-Scholes option pricing model, an expected term equal to the option term, a risk-free interest rate corresponding to the expected term, an expected volatility of 60% 70% and a dividend yield of zero.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

2. Stock Option Plans, Stock-Based Compensation and Common Stock (Continued)

Deferred compensation was recorded in connection with stock option grants made prior to the Company's IPO. The deferred compensation represents the difference between the estimated market value of common stock on the date of grant and the exercise price associated with the stock options. All remaining deferred compensation has been amortized to expense over the vesting period of the related stock options.

Total unrecognized stock-based compensation costs related to non-vested stock options was approximately $8,211,907 which related to approximately 1,085,591 shares with a per share weighted fair value of $7.56 as of December 31, 2007. This unrecognized cost is expected to be recognized over a weighted average period of approximately 2.3 years.

As of December 31, 2007, there were 1,731,089 stock options vested and expected to vest with a weighted average exercise price of $11.92 per share, a weighted average contractual remaining life of 7.9 years and an aggregate intrinsic value of $1,305,157. Expected to vest options are determined by applying the pre-vesting forfeiture rate to the total outstanding options. Aggregate intrinsic value represents the total pre-tax intrinsic value (the aggregate difference between the closing stock price of the Company's common stock as of December 31, 2007, as applicable, and the exercise price for the in-the-money options) that would have been received by the option holders if all the in-the-money options had been exercised on December 31, 2007.

Common Stock

As of December 31, 2007, the Company had 50,000,000 shares of common stock authorized and 13,690,132 shares issued and outstanding. There were no treasury shares outstanding at December 31, 2007 and 2006, as all treasury shares have been issued upon employee stock option exercises.

Each share of common stock entitles the holder to one vote on all matters submitted to a vote of the Company's stockholders. Common stockholders are not entitled to receive dividends unless declared by the Board of Directors.

At December 31, 2007, the Company has reserved authorized shares of common stock for future issuance as follows:

Outstanding stock options	1,848,892
Possible future issuance under stock option plans	611,906
Possible future issuance under employee stock purchase plan	286,407
Total	2,747,205

On March 7, 2007, the Company's Board of Directors adopted a Shareholder Rights Plan and declared a dividend distribution of one preferred stock purchase right for each outstanding share of the Company's common stock to shareholders of record as of the close of business on March 8, 2007.

3. Acquisition

On December 26, 2007, the Company acquired substantially all of the assets of EyeTel for an aggregate purchase price of 1,050,297 shares of the Company's common stock, $175,000 in cash and the assumption of certain specified liabilities totaling $804,916. EyeTel was engaged in the design, development, and commercialization of proprietary medical devices, including the DigiScope, a device

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

3. Acquisition (Continued)

that helps physicians detect eye disorders such as diabetic retinopathy, the leading cause of blindness in patients with diabetes. The Company had previously entered into an exclusive licensing agreement with EyeTel pursuant to which the Company had sales and marketing rights to the DigiScope in the primary diabetes care physician market. The acquisition is intended to further diversify the Company's proprietary medical device product offering and expand sales into additional markets such as the optometry market.

In accordance with the provisions of SFAS No. 141, "*Business Combinations*" the assets acquired and liabilities assumed have been recorded at their estimated fair value. A total of $2.8 million was allocated to intangible assets, representing the fair value of existing technology, which is being amortized on a straight line basis over the estimated life of five years. The fair value of the intangible assets was determined primarily through assessments by the Company's management and the fair value of the tangible assets acquired and liabilities assumed approximated their carrying values. Goodwill totaling $5.8 million was recorded in connection with the acquisition, representing the excess of the purchase price over the estimated fair value of the acquired tangible assets, intangible assets and assumed liabilities.

The purchase price was allocated to the acquired tangible assets, intangible assets and assumed liabilities based on their estimated fair values at the date of acquisition as follows:

Cash	$	175,000
Issuance of 1,050,297 shares of NeuroMetrix Common Stock		9,784,548
Acquisition costs		150,000
Total consideration	$	10,109,548
Net tangible assets:		
Restricted cash	$	45,000
Accounts receivable		35,000
Fixed assets		1,985,000
Other current assets		216,000
Accounts payable and accrued expenses		(804,916)
Net tangible assets		1,476,084
Other intangible assets		2,800,000
Goodwill		5,833,464
Total	$	10,109,548

Pro Forma Financial Summary (Unaudited)

The following unaudited pro forma financial summary is presented as if the acquisition of substantially all of the assets of EyeTel was completed as of the beginning of each period presented. The pro forma combined results are not necessarily indicative of the actual results that would have

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

3. Acquisition (Continued)

occurred had the acquisition been consummated on that date, or of the future operations of the combined entities.

	Years Ended December 31,	
	2007	2006
Total revenues	$ 44,814,865	$ 56,455,840
Net loss	$ (19,760,624)	$ (3,096,033)
Basic and diluted loss per common share	$ (1.44)	$ (0.23)
Basic and diluted weighted average shares used to compute net loss per common share	13,678,607	13,552,039

4. Inventories

At December 31, 2007 and 2006, inventories consist of the following:

	December 31,	
	2007	2006
Purchased components	$ 1,216,758	$ 345,852
Finished goods	4,137,580	3,287,537
	$ 5,354,338	$ 3,633,389

5. Investments

Short-Term Held-to-Maturity

Held-to-maturity investments as of December 31, 2007 and 2006 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
2007				
Commercial paper and bank notes	$ 964,900	$ 9,960	$	$ 974,860
Corporate bonds	21,656,841	5,049	(25,807)	21,636,083
	$ 22,621,741	$ 15,009	$ (25,807)	$ 22,610,943
2006				
Commercial paper and bank notes	$ 3,895,713	$ 104,287		$ 4,000,000
U.S. agency obligations	997,752	998		998,750
Corporate bonds	27,517,220	1,983	(17,656)	27,501,547

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	$ 32,410,685	$ 107,268	$ (17,656)	$ 32,500,297

The following table shows the gross unrealized losses and fair value of the Company's held-to-maturity investments with unrealized losses that are not deemed to be other-than-temporarily

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

5. Investments (Continued)

impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007 and 2006:

	12 Months or less		Greater than 12 Months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
2007						
Corporate bonds	$ 15,701,223	$ (25,807)	$	$	$ 15,701,223	$ (25,807)
2006						
Corporate bonds	$ 24,478,947	$ (17,656)	$	$	$ 24,478,947	$ (17,656)

Corporate bonds At December 31, 2007, the Company held 13 corporate bonds in an unrealized loss position which was primarily the result of higher market interest rates since the date of purchase, rather than a decline in credit quality of these investments. The contractual terms of these investments do not permit the issuers to settle the securities at a price less than the face value of the investment. Each of the bonds maintains a Standard & Poor's rating of A or higher and has made each of their scheduled interest payments. Therefore, it is not expected that the bonds would be settled at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold these investments until maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2007.

The amortized cost and fair value of fixed maturity securities at December 31, 2007 and 2006, by contractual maturity, are shown below:

	December 31,			
	2007		2006	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 22,621,741	$ 22,610,943	$ 32,410,685	$ 32,500,297

Long-Term Available-for-Sale Investment

In November 2007, the Company made an investment of $2.5 million for the purchase of approximately 5.4 million shares of common stock of Cyberkinetics, representing approximately 13% of the Cyberkinetics' issued and outstanding shares at the time of the investment, at a price of $0.46 per share. The Company also received a warrant to purchase up to approximately 2.7 million shares of Cyberkinetics common stock. The warrant is exercisable at $0.46 per share and has a term of five years, but will be required to be exercised if Cyberkinetics receives FDA approval of an HDE filing for the Andara OFS device for acute spinal cord injuries.

In accordance with SFAS No. 115, the investment in Cyberkinetics common stock and warrants is being accounted for as available-for-sale and has been recorded at an estimated value of $1.1 million as of December 31, 2007. The adjustment to the carrying value of the investment in Cyberkinetics to estimated value as of December 31, 2007 has been recorded in accumulated other comprehensive loss within stockholders' equity. The Company will review the carrying value of this investment quarterly to

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

5. Investments (Continued)

determine whether an other than temporary decline in market value exists. The Company considers factors such as the length of time the value of the investment has been below its original purchase price, the financial condition of the investee and near-term prospects for the investee's recovery to original purchase price and the Company's intent with regard to the underlying investment. Based on the Company's assessment as of December 31, 2007, and taking into consideration the volatility of Cyberkinetics' common stock and the time period the investment has been in an unrealized loss position, the Company does not believe that the decline in value of the investment is other than temporary in nature.

In connection with the investment in Cyberkinetics, the Company also received certain rights, including a right of first negotiation for the acquisition of Cyberkinetics, or any other change of control transaction, and a right of first negotiation for the commercialization of the Andara OFS device for the treatment of acute spinal cord injuries. In addition, the Company received a seat on the Cyberkinetics Board of Directors. Dr. Shai Gozani M.D. Ph.D., the Company's Chief Executive Officer and President, has been named as the initial designee.

In February 2008, The Company entered into a Collaboration Agreement and Operating Agreement with Cyberkinetics to develop and commercialize products for the treatment of peripheral nerve injury and formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture with initial ownership of 50% held by the Company and 50% held by Cyberkinetics. (See Note 11. Subsequent Events)

6. Fixed Assets

Fixed assets consist of the following:

	Estimated Useful Life	December 31,	
	(Years)	2007	2006
Computer and laboratory equipment	3	$ 1,908,750	$ 1,746,322
Furniture and equipment	3	411,116	350,678
DigiScope equipment	5	1,985,000	
Production equipment	7	665,267	665,266
Construction in progress		288,829	215,476
Leasehold improvements	*	150,097	150,097
		5,409,059	3,127,839
Less accumulated depreciation		(2,435,341)	(2,012,403)
		$ 2,973,718	$ 1,115,436

* Lesser of life of lease or estimated useful life.

Depreciation expense was $422,938, $380,655 and $278,932 for the years ended December 31, 2007, 2006 and 2005, respectively.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

6. Fixed Assets (Continued)

DigiScope equipment acquired, in conjunction with the Company's December 26, 2007 acquisition of substantially all of the assets of EyeTel, consists of equipment and sub-assemblies leased to customers.

A capital lease is included as a component of furniture and equipment at December 31, 2007. Amortization of assets under this capital lease was $7,525 and is included in depreciation expense for the year ended December 31, 2007.

7. Accrued Expenses

Accrued expenses consist of the following for the years ended December 31, 2007 and 2006:

	December 31,	
	2007	2006
Professional services	$ 706,952	$ 401,186
Sales taxes	489,555	2,851,307
Other	1,112,056	1,023,490
	$ 2,308,563	$ 4,275,983

8. Income Taxes

The income tax provision consists of the following for the years ended December 31, 2007, 2006 and 2005:

	Years Ended December 31,		
	2007	2006	2005
Federal tax expense	$	$ 193,000	$ 35,000
State tax expense			
Total	$	$ 193,000	$ 35,000

The Company's effective income tax rate differs from the statutory federal income tax rate as follows for the years ended December 31, 2007, 2006 and 2005.

	Years Ended December 31,		
	2007	2006	2005
Federal tax provision (benefit) rate	34.0%	34.0%	34.0%
State tax provision, net of federal provision (benefits)	4.6	7.6	9.9
Permanent items	(1.1)	11.1	56.3
Research and development tax credits	0.5	(4.2)	(54.5)
Alternative minimum tax		4.3	12.3
Alternative minimum tax credit		(2.7)	
Valuation allowance	(38.0)	(45.8)	(45.7)
Effective income tax rate	%	4.3%	12.3%

	Years Ended December 31,		

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

8. Income Taxes (Continued)

The Company's net deferred tax assets consist of the following:

	December 31,	
	2007	**2006**
Deferred tax assets:		
Net operating loss carryforwards	$ 11,797,528	$ 9,373,722
Research and development credit carryforwards	957,221	978,653
Alternative minimum tax credit	120,490	120,195
Accrued expenses	1,713,220	2,808,024
Other	1,650,107	522,822
Total gross deferred tax assets	16,238,566	13,803,416
Valuation allowance	(16,238,566)	(13,803,416)
Net deferred tax assets	$	$

At December 31, 2007, the Company has federal and state net operating loss carryforwards ("NOL") of approximately $37.0 million and $21.1 million, respectively, as well as federal and state tax credits of $598,000 and $544,000, respectively, which may be available to reduce future taxable income and the related taxes thereon. This amount includes tax benefits of $3.8 million and $71,000 attributable to NOL and tax credit carryforwards, respectively, that result from the exercise of employee stock options. The tax benefit of these items will be recorded as a credit to additional paid-in capital upon realization of the deferred tax asset or reduction in income taxes payable. The federal NOLs begin to expire in 2019 and the state NOLs begin to expire in 2008.

As required by SFAS No. 109 "*Accounting for Income Taxes*" ("SFAS No. 109"), the Company has evaluated the positive and negative evidence bearing upon the realizability of its deferred tax assets, which are comprised principally of net operating losses. Management has determined that it is more likely than not that the Company will not recognize the benefits of federal and state deferred tax assets and, as a result, a valuation allowance of approximately $16.2 million and $13.8 million has been established at December 31, 2007 and 2006, respectively

Ownership changes, as defined in the Internal Revenue Code, have limited the amount of net operating loss carryforwards that can be utilized annually to offset future taxable income. The Company anticipates that these limitations will have no material impact on their ability to utilize the affected loss carryforwards in future years. Subsequent ownership changes could further impact the limitation in future years.

In June 2006, the FASB issued FIN 48. FIN 48 requires management to perform a two-step evaluation of all tax positions, ensuring that these tax return positions meet the "more-likely than not" recognition threshold and can be measured with sufficient precision to determine the benefit recognized in the financial statements. These evaluations provide management with a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements certain tax positions that the Company has taken or expects to take on income tax returns. Management estimated that as of December 31, 2006, there was an uncertain tax position totaling approximately $100,000 relating to the Company's tax credit carryforwards. As a result, the Company reduced its deferred tax assets and the associated valuation allowance by approximately $100,000 as of

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

8. Income Taxes (Continued)

January 1, 2007, the adoption date of FIN 48. There have been no other activities impacting FIN 48 reserves during the year ended December 31, 2007.

9. Commitments and Contingencies

Cyberkinetics

In connection with the Company's investment in Cyberkinetics, the Company received a warrant to purchase up to approximately 2.7 million shares of Cyberkinetics common stock. The warrant, exercisable at $0.46 per share, or approximately $1.25 million, has a term of five years, and is required to be exercised if Cyberkinetics receives FDA approval of an HDE filing for the Andara OFS device for acute spinal cord injuries.

In February 2008, the Company entered into a Collaboration Agreement and Operating Agreement with Cyberkinetics to develop and commercialize products for the treatment of peripheral nerve injury and formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture with 50% ownership held by the Company and 50% ownership held by Cyberkinetics. Under the terms of the joint venture, the Company has agreed to fund the initial $2.0 million in product development costs and has agreed to share equally in all costs in excess of the initial $2.0 million. Cyberkinetics has agreed to contribute technology, know-how and intellectual property, primarily relating to their Andara OFS technology, to the joint venture.

Operating Leases

In September 2000, the Company entered into a non-cancelable operating lease, commencing January 1, 2001, for office and laboratory space. The lease expires on March 31, 2009.

Future minimum lease payments under noncancelable operating leases as of December 31, 2007 are as follows:

2008	$	930,000
2009		232,500
Total minimum lease payments	$	1,162,500

Total recorded rent expense was $871,819 for each the years ended December 31, 2007, 2006 and 2005. The Company records rent expense on its facility lease on a straight line basis over the term. Accordingly, the Company has recorded a liability for accrued rent expense at December 31, 2007 and 2006 of $72,727 and $130,909, respectively on the accompanying balance sheets. See Note 11 Subsequent Events Lease Agreement.

Capital Lease

In June 2007, the Company entered into a non-cancelable capital lease for copiers located at our corporate headquarters valued at $38,700. The lease expires in May 2010.

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

9. Commitments and Contingencies (Continued)

Future minimum lease payments under the capital lease as of December 31, 2007, are as follows:

2008	$ 12,900
2009	12,900
2010	5,375
Total capital lease payments	$ 31,175

Restricted Time Deposit

In connection with the Company's facility lease, the Company is required to maintain, for the benefit of the lessor, an irrevocable standby letter of credit stating the lessor as the beneficiary over the term of the lease, which is secured by a certificate of deposit in an amount equal to 102% of the letter of credit, as security. The lease expires in March 2009. The certificate of deposit is renewable annually. At December 31, 2007 and 2006, the Company has $1,458,598 recorded as restricted cash associated with this lease on the accompanying balance sheet. See Note 11 Subsequent Events Lease Agreement.

Legal Matters

In the second quarter of 2006, the Company received a subpoena from the Office of Inspector General ("OIG"), of the Department of Health and Human Services requesting documents in connection with an investigation of potential violations of the federal anti-kickback statute and False Claims Act. In addition, on June 21, 2007, the Company received a subpoena from the U.S. Attorney's Office for the District of Massachusetts requesting documents in connection with an investigation by the United State Department of Justice ("DOJ"). The DOJ is investigating various aspects of the Company's practices relating to the NC-stat System, including sales and marketing practices. The Company is cooperating with both investigations. During 2007, the Company formed a Special Committee of its Board of Directors to provide oversight of an ongoing independent review of the Company's sales and marketing practices and of the Company's continuing cooperation with the DOJ and OIG investigations. The Company cannot predict the ultimate outcome of these investigations. The Company is unable to determine when these matters will be resolved, whether any additional areas of inquiry will be opened, or any outcome of this matter. Any negative findings in this matter could result in fines, penalties, or program exclusions, which could have a material adverse effect on the Company's financial condition, results of operations, and cash flows.

10. Retirement Plan

The Company established a 401(k) defined contribution savings plan for its employees who meet certain service period and age requirements. Contributions are permitted up to the maximum allowed under the Internal Revenue Code of each covered employee's salary. The savings plan permits the Company to contribute at its discretion. For the years ended December 31, 2007, 2006 and 2005 the Company made no contributions to the plan.

11. Subsequent Events

Joint Venture with Cyberkinetics

In February 2008, the Company and Cyberkinetics formed PNIR (Peripheral Nerve Injury Repair) LLC, a joint venture incorporated in Delaware, and entered into a Collaboration Agreement

NeuroMetrix, Inc.

Notes to Financial Statements(Continued)

11. Subsequent Events (Continued)

and Operating Agreement to develop and commercialize products for the treatment of peripheral nerve injury. The joint venture is initially 50% owned by the Company and 50% owned by Cyberkinetics. Under the terms of the joint venture, the Company has agreed to fund the initial $2.0 million in product development costs and the Company and Cyberkinetics have agreed to share equally in all costs in excess of the initial $2.0 million. Cyberkinetics has agreed to contribute technology, know-how and intellectual property, primarily relating to their Andara OFS technology, to the joint venture.

The Company obtained sales and marketing rights and Cyberkinetics obtained commercial manufacturing rights to any products commercialized under the joint venture. Each party will charge the joint venture at cost for all expenses incurred in connection with their respective commercialization activities. Profits and losses realized from the joint venture will be split equally between the Company and Cyberkinetics based on the initial ownership percentage.

Lease Agreement

In February 2008, the Company amended the Lease Agreement dated October 18, 2000 between Fourth Avenue LLC and the Company for office and engineering laboratory space. The amendment extends the term of the lease, currently scheduled to expire on March 31, 2009, through March 31, 2013. Base rent for the period April 2009 through March 2013 will be reduced from the current level of $930,000 annually to a range of $675,000 to $765,000 annually.

In connection with the amendment of the lease, the amount of the irrevocable letter of credit required to be maintained by the Company for the benefit of the lessor will be reduced from $1,430,000 to $400,000. The letter of credit must be secured by a certificate of deposit in an amount equal to 102% of the letter of credit as security.

NeuroMetrix, Inc.

Schedule II Valuation and Qualifying Accounts

Description	Balance at Beginning of Period	Additions: Charged to costs and expenses	Additions: Charged to other accounts (Describe)(1)	Deductions (Describe)	Balance at End of Period
December 31, 2007					
Allowance for Doubtful Accounts	$ 900,000	$ 358,141	$ 195,875	$ (548,016)(2)	$ 906,000
Deferred Tax Asset Valuation Allowance	13,803,416	2,642,021		(206,871)(3)	16,238,566
December 31, 2006					
Allowance for Doubtful Accounts	400,000	946,850	74,539	(521,3897)(2)	900,000
Deferred Tax Asset Valuation Allowance	16,081,539	2,226,513		(4,504,636)(3)	13,803,416
December 31, 2005					
Allowance for Doubtful Accounts	300,000	281,684	78,143	(259,8277)(2)	400,000
Deferred Tax Asset Valuation Allowance	14,235,366	1,846,173			16,081,539

(1) Recoveries.

(2) Write-offs.

(3) Utilization and expiration of Federal and State Net Operating Loss Carryforwards.

S-1