Solexa, Inc.
Form 10-Q
August 14, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

for the quarterly period ended June 30, 2006

OR

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

for the transition period from _____ to _____

Commission File Number 0-22570

Solexa, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**94-3161073**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

25861 Industrial Blvd., Hayward, CA 94545

(Address of principal executive offices)

(510) 670-9300

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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 number of shares of common stock outstanding as of August 1, 2006 was 36,539,073

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For the Quarter Ended June 30, 2006
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

SOLEXA, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)
(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 58,085	$ 38,403
Accounts receivable	377	539
Inventory	2,262	754
Other current assets	4,453	2,422
Total current assets	65,177	42,118
Property and equipment, net	4,636	4,378
Intangible assets, net	3,338	3,510
Goodwill	22,529	22,529
Other non-current assets	470	482
Total assets	$ 96,150	$ 73,017
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,940	$ 2,235
Accrued compensation	3,177	2,067
Accrued professional fees	893	705
Equipment financing, current portion	30	31
Forward loss contingency	28	1,028
Deferred revenue, current portion	727	1,518
Deferred rent and lease obligations	929	801
Other accrued liabilities	301	529
Total current liabilities	9,025	8,914
Deferred revenues, net of current portion	2,213	1,905
Equipment financing, net of current portion	30	44
Deferred rent and lease obligations, net of current portion	1,885	2,381
Stockholders equity:		
Preferred stock: $0.01 par value; 2,000 shares authorized; no shares issued and outstanding at June 30, 2006 and December 31, 2005		
Common stock: $0.01 par value; 60,000 shares authorized; 36,501 shares and 30,027 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	365	300
Additional paid-in capital	150,574	109,575
Deferred compensation		(326)
Accumulated other comprehensive income	3,014	2,064

Accumulated deficit	(70,956)	(51,840)
Total stockholders equity	82,997	59,773
Total liabilities and stockholders equity	$ 96,150	$ 73,017

See accompanying notes.

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SOLEXA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Revenues:				
Service revenue	$ 963	$ 1,399	$ 1,731	$ 2,004
Other revenue	134		134	
Total revenue	1,097	1,399	1,865	2,004
Operating costs and expenses:				
Cost of service revenue	917	1,738	1,828	2,278
Manufacturing startup costs	724		724	
Research and development	5,485	4,653	11,818	7,646
Sales, general and administrative	4,797	4,130	8,614	6,463
Restructuring charge		333		333
Total operating costs and expenses	11,923	10,854	22,984	16,720
Loss from operations	(10,826)	(9,455)	(21,119)	(14,716)
Interest income	699	91	1,354	227
Interest expense	(161)	(432)	(317)	(564)
Other income (expense), net		(4)		(7)
Gain on foreign exchange	67	415	117	415
Loss from operations	(10,221)	(9,385)	(19,965)	(14,645)
Income tax benefit related to foreign research and development tax credit	(438)		(849)	
Net loss	(9,783)	(9,385)	(19,116)	(14,645)
Dividends to A ordinary and B preferred shares				(522)
Net loss attributable to common shareholders	$ (9,783)	$ (9,385)	$ (19,116)	$ (15,167)
Basic and diluted net loss per common share	$ (0.27)	$ (0.48)	$ (0.53)	$ (1.19)
Shares used in computation of net loss per common share	36,491	19,354	35,806	12,717

See accompanying notes.

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SOLEXA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30,	
	2006	**2005**
Operating activities:		
Net loss	$ (19,116)	$ (14,645)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,458	1,941
Stock based compensation expense	1,978	47
Business combination engagement fees		987
Amortization of warrant value related to note payable		139
Changes in operating assets and liabilities:		
Accounts receivable	161	319
Inventory	(1,508)	389
Other assets	(1,879)	1,201
Accounts payable	668	(2,741)
Forward loss contingency	(1,000)	
Other accrued liabilities	1,266	352
Deferred revenues	(483)	(872)
Non-current liabilities	(496)	(185)
Net cash used in operating activities	(18,951)	(13,068)
Investing activities:		
Purchases of property and equipment	(1,392)	(791)
Cost associated with a patent purchase		(75)
Costs paid in connection with the business combination		(642)
Net cash used in investing activities	(1,392)	(1,508)
Financing activities:		
Issuance of common stock, net of issuance costs	37,799	7,813
Proceeds from the exercise of stock options	214	308
Proceeds from the exercise of warrants	1,260	
Proceeds from equipment sale and leaseback		93
Repayment of equipment loans	(18)	(13)
Net cash provided by financing activities	39,255	8,201
Net increase (decrease) in cash and cash equivalents	18,912	(6,375)
Effect of exchange rate differences on cash and cash equivalents	770	(451)
Cash and cash equivalents at beginning of period	38,403	10,463
Cash and cash equivalents at end of period	$ 58,085	$ 3,637

Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 161	$ 263
Supplemental disclosure of non-cash financing activities:		
Issuance of common stock in payment of board fees	$ 140	$

See accompanying notes.

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SOLEXA, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006

1. Description of Business

Solexa, Inc. (Solexa, or the Company) is in the business of developing and commercializing genetic analysis technologies. We currently generate service revenues in our genomics services business from processing biological samples supplied to us by customers using our MPSS technology. We intend to discontinue providing MPSS services in 2006. We are currently developing and commercializing a novel instrumentation system for genetic analysis, the Solexa Genome Analysis System, based on our reversible-terminator Sequencing-by-Synthesis, or SBS, chemistry and based on our Clonal Single Molecule Array ™ technology. This platform is expected to support many types of genetic analyses, including DNA sequencing, gene expression and small RNA analysis. We believe that this technology, which can potentially generate over a billion bases of DNA sequence from a single experiment with a single sample preparation, will dramatically reduce the cost, and improve the practicality, of human re-sequencing relative to conventional technologies. We commenced commercial shipment of our first-generation system, including the 1G Genome Analyzer, in the second quarter of 2006. We believe our new DNA sequencing system will enable us to implement a new business model based primarily on the sale of genetic analysis equipment, reagents and other consumables and services to end user customers. Our longer-term goal is to further reduce the cost of human re-sequencing to a few thousand dollars for use in a wide range of applications from basic research through clinical diagnostics.

2. Basis of Presentation

On March 4, 2005, Solexa Limited, a privately held United Kingdom company, and Lynx Therapeutics, Inc., a Delaware corporation, completed a business combination. Solexa Limited became a wholly owned subsidiary of Lynx as a result of the transaction, and Lynx changed its name to Solexa, Inc. However, because immediately following the business combination transaction the former Solexa Limited shareholders owned approximately 80% of the shares of the common stock of Lynx, Solexa Limited s designees to the combined company s board of directors represented a majority of the combined company s directors and Solexa Limited s senior management represented a majority of the senior management of the combined company, Solexa Limited is deemed to be the acquiring company for accounting purposes. Accordingly, the assets and liabilities of Lynx were recorded, as of the date of the business combination, at their respective fair values and added to those of Solexa Limited. Results of operations of the combined company for the six months ended June 30, 2005, reflect those of Solexa Limited, to which the results of operations of Lynx were added from the date of the consummation of the business combination. The results of operations of the combined company reflect purchase accounting adjustments, including increased amortization and depreciation expense for acquired net assets.

In connection with this business combination transaction, Lynx changed its name to Solexa, Inc. and its trading symbol to SLXA. Unless specifically noted otherwise, as used throughout these Consolidated Financial Statements, Lynx Therapeutics or Lynx refers to the business, operations and financial results of Lynx Therapeutics, Inc. prior to the business combination consummated on March 4, 2005, Solexa Limited refers to the business of Solexa Limited, a privately held United Kingdom company prior to the business combination, Solexa refers to the business of the combined company after the business combination, and we refers to either the business operations and financial results of Solexa Limited prior to the business combination or the business of the combined company after the business combination, as the context requires.

The accompanying unaudited condensed consolidated financial statements included herein have been prepared by Solexa without audit, pursuant to the rules and regulations promulgated by the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to SEC rules and regulations; nevertheless, Solexa believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company for the interim periods presented. Revenues, expenses, assets and liabilities can vary during each quarter of the year.

Therefore, the results and trends in these interim consolidated condensed financial statements may not be indicative of results for any other interim period or for the entire year. These condensed consolidated financial statements should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2005, which are contained in the Company s Annual Report on Form 10-K filed with the SEC on March 31, 2006.

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The unaudited condensed consolidated financial statements include all accounts of Solexa and our wholly owned subsidiaries, Solexa Limited and Lynx Therapeutics GmbH. All intercompany balances and transactions have been eliminated.

Certain prior year amounts have been reclassified to conform to the current year presentation. Specifically, certain amounts in the condensed consolidated statements of operations were reclassified between research and development expense, sales, general and administrative expense, interest income and interest expense. These reclassifications have no impact on our previously reported net losses.

3. Summary of Significant Accounting Policies

Use of Estimates

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

Stock-Based Employee Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123R, Share Based Payment (Revised 2004) (SFAS 123R) on the modified prospective basis. As a result, the Company has included stock-based employee compensation costs in its results of operations for the three months and six months ended June 30, 2006, as more fully described in Note 4 to the Company s condensed consolidated financial statements.

V*aluation and amortization method* The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing formula and a single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

Concentrations and Geographic Information

Revenue from three customers represented 47%, 15% and 11% of the Company s revenue for the three months ended June 30, 2006 and 48%, 15% and 12% for the six months ended June 30, 2006, respectively. Revenue from two customers represented 61% and 13% of the Company s revenue for the three months ended June 30, 2005 and 60% and 10% for the six months ended June 30, 2005, respectively.

In the three months and six months ended June 30, 2006 and the corresponding periods of 2005, revenues have been derived primarily from contracts with customers located in the United States and other countries as follows (revenues are attributed to geographic areas based on the location of the customer, in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
United States	$ 939	$ 1,257	$ 1,654	$ 1,841
United Kingdom	158	72	181	93
Other		70	30	70
	$ 1,097	$ 1,399	$ 1,865	$ 2,004

Net Loss Per Share

Basic net loss per share has been computed using the weighted-average number of shares of common stock for the three months and six months ended June 30, 2006 and of common stock and ordinary shares outstanding for the three months and six months ended June 30, 2005.

Common stock equivalents were not included in the computation of diluted net loss per share, as their effect was anti-dilutive for the periods presented. Therefore, both the basic and diluted net loss per share computations resulted in the same number of shares, and

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there were no reconciling items. These common stock equivalents will be included in the calculation at such time as the effect is no longer anti-dilutive, as calculated using the treasury stock method. Options and warrants to purchase 11,584,663 and 3,753,422 common shares as of June 30, 2006 and 2005, respectively, were not considered in the computation of basic and diluted net loss per share.

Recent Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board (the FASB) issued FASB Staff Position No. 123(R)-3 (FSP FAS 123(R)-3), Transition Election to Accounting for Tax Effects of Share-Based Payment Awards. This pronouncement provides an alternative method of calculating the excess tax benefits available to absorb any tax deficiencies recognized subsequent to the adoption of SFAS 123R. The Company has until November 2006 to make a one-time election to adopt the transition method. The Company is currently evaluating FSP FAS 123(R)-3 and whether to make this election. This one-time election will not affect operating loss or net loss.

In June 2006, the FASB issued FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes* . FIN 48 provides interpretive guidance for recognition and measurement of tax positions taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are reviewing the impact of FIN 48, but do not expect the adoption of FIN 48 to have a material impact on our consolidated financial statements.

In November, 2004, the FASB issued SFAS No. 151, Inventory Costs An Amendment to ARB No. 43, Chapter 4 . SFAS No. 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing , to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that other items such as abnormal freight, handling costs and amounts of wasted materials (spoilage) require treatment as current period charges rather than as a portion of the inventory cost regardless of whether they meet the criterion of so abnormal as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005, and has become applicable to the Company in the second quarter of fiscal 2006 with the commencement of commercial production of the Solexa Genome Analysis System.

4. Stock-based Employee Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123R, Share Based Payment (SFAS 123R), using the modified prospective application method. Under this method, all employee stock-based payments, including grants of stock options, are recognized in the income statement as an operating expense, based on their fair values over the requisite service period. Awards that are granted after January 1, 2006 were measured and non-cash employee compensation expenses were recognized in the consolidated statements of operations in accordance with SFAS 123R. In addition, the non-vested portion of awards as of January 1, 2006 also resulted in recognition of non-cash employee compensation expense. The Company recognizes share-based employee compensation expense ratably over the vesting period of options, adjusted for the expected forfeiture rate. The expenses were included in the consolidated statements of operations as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Manufacturing start up costs	$ 25	$ 25
Cost of service revenue	7	13
Research and development	359	674
Sales, general and administrative	561	1,086
Non-cash stock-based employee compensation expense	$ 952	$ 1,798

For the three months and six months ended June 30, 2006, in accordance with SFAS 123R, the Company recognized non-cash stock-based employee compensation expenses of $952,000 and $1.8 million, respectively. Both

basic and diluted loss per share for the three months and six months ended June 30, 2006 where $0.03 and $0.05 higher, respectively, than if the Company had not adopted SFAS 123R and continued to account for stock-based compensation under APB 25. Stock-based employee compensation costs capitalized into inventory and charged against the forward loss contingency were $5,000 and $6,000, respectively for the three months ended June 30, 2006 and $12,000 and $13,000, respectively for the six months ended June 30, 2006.

As of June 30, 2006, total unrecognized compensation costs related to non-vested awards of $11.5 million are expected to be recognized over a weighted average period of approximately 3.01 years.

Under SFAS 123R, we estimate the fair value of stock options at the date of grant using the Black-Scholes option valuation model. Expected volatility is based on trading activity of the Company since the business combination between Solexa Limited and Lynx Therapeutics, Inc. and that of certain comparable companies in our industry. The Company uses an estimate of the expected life based on the weighted-average difference between the vesting term and the contract term. The risk-free rate for periods within the

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contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The fair value of options at date of grant and the assumptions utilized to determine such values are indicated in the following table:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Risk-free interest rate	5.10%	4.92%
Expected volatility	0.80	0.85
Expected life (in years)	6.08	6.05
Expected dividend yield	0%	0%

Prior to the adoption of SFAS 123R, we applied SFAS 123, amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), which allowed companies to apply the existing accounting rules under APB 25, Accounting for Stock Issued to Employees , and related Interpretations. Periods prior to the adoption of 123R have not been restated. In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in our net income (loss) for period prior to the adoption of SFAS 123R. As required by SFAS 148 prior to the adoption of SFAS 123R, we provided pro forma net loss and pro forma net loss per share disclosures for stock-based awards, as if fair-value-based method defined in SFAS 123 had been applied.

The following table illustrates the effect on net loss after tax and net loss per share as if we had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three month and six month period-ended June 30, 2005 (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (9,385)	$ (15,167)
Add: Stock-based employee compensation as reported	34	47
Deduct: Stock-based employee compensation as if fair value method applied to all awards	(2,043)	(2,057)
Net loss, pro forma as if fair value method applied to all awards	$ (11,394)	$ (17,177)
Basic and diluted net loss per share, as reported	$ (0.48)	$ (1.19)
Basic and diluted net loss per share, pro forma as if fair value method applied to all awards	$ (0.59)	$ (1.35)

For the three months and six months ended June 30, 2006, the only stock option plan under which the Company awarded new grants to employees was the 2005 Equity Incentive Plan. The 2005 Equity Incentive Plan awards generally vest either ratably over four years of service or one quarter at the end of the first year and then ratably over the following three years of service and have a contractual life of 10 years. At June 30, 2006, the Company has 145,145 shares available for grant under the 2005 Equity Incentive Plan. Option transactions under all the Company plans during the two quarters ended June 30, 2006 are summarized as follows:

	Number of	Weighted Average	Weighted-Average Remaining Contractual	Aggregate Intrinsic

	Shares (In thousands)	Exercise Price	Term (In years)	Value (In thousands)
Outstanding at December 31, 2005	3,090,308	$ 6.15		
Granted	497,500	9.17		
Exercised	(14,211)	6.84		
Forfeited	(51,373)	6.28		
Outstanding at March 31, 2006	3,522,224	$ 6.57	8.82	$ 14,782
Granted	248,000	9.01		
Exercised	(21,299)	5.50		
Forfeited	(41,931)	6.05		
Outstanding at June 30, 2006	3,706,994	$ 6.75	8.67	$ 9,765
Exercisable at June 30, 2006	1,291,699	$ 7.15	7.78	$ 4,509

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The weighted average fair value of options granted during the three months and six months ended June 30, 2006 was $6.52 and $6.75, respectively.

Cash received from options exercised during the three months and six months ended June 30, 2006 was approximately $117,000 and $214,000, respectively. In connection with these exercises, there was no tax benefit realized by the Company due to the Company s current loss position.

We have not recorded any deferred tax assets related to the compensation costs that result from the adoption of SFAS 123R because the utilization of such assets or liabilities is dependent upon future earnings, if any. We are uncertain about the timing and amount of any future earnings. We have concluded that it was more likely than not that such deferred tax assets would not be realized. Accordingly, all of our deferred tax assets have been fully offset by a valuation allowance as of June 30, 2006.

5. Balance Sheet Accounts

Inventory consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Raw materials	$ 1,537	$ 213
Work in process	725	541
	$ 2,262	$ 754

Other current assets consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Prepaid expenses	904	544
Research and development tax credit receivable	2,920	1,789
Other	629	89
	$ 4,453	$ 2,422

Property and equipment consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Leasehold improvements	$ 3,562	$ 3,500
Laboratory and other equipment	7,602	6,288
	11,164	9,788
Less accumulated depreciation and amortization	(6,528)	(5,410)
	$ 4,636	$ 4,378

6. Forward Loss Contingency

In our genomics services business, we enter into service contracts to provide genetic analysis on samples provided to us by customers. If management considers it probable that performance on the contract will result in a loss and this loss can be reasonably estimated, a loss reserve is recorded.

Changes in the forward loss reserves during the three months and six months ended June 30, 2006 and 2005 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Balance at beginning of period	$ 364	$	$ 1,028	$
Loss experienced on completed samples	(336)		(1,005)	
Reversal of forward loss accrual for completed contracts			(72)	
Change in forward loss estimate			77	
Balance at June 30	$ 28	$	$ 28	$

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In addition, we recorded zero and $207,000 in cost of service revenue during the three and six months ended June 30, 2006, respectively, for the cost of samples in excess of our estimates at the beginning of the year.

7. Comprehensive Loss

The following are the components of comprehensive loss (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net loss	$ (9,783)	$ (9,385)	$ (19,116)	$ (15,167)
Currency translation	834	199	950	190
Comprehensive loss	$ (8,949)	$ (9,186)	$ (18,166)	$ (14,977)

8. Commitments and Contingencies

We lease facilities and certain equipment under non-cancelable operating leases with various expiration dates through 2008. Future minimum lease payments under non-cancelable operating leases as of June 30, 2006 are as follows (in thousands):

	Operating Leases
Remainder of 2006	$ 1,615
2007	3,323
2008 and thereafter	3,287
Total minimum payments	$ 8,225

9. Stockholders Equity

On November 18, 2005, Solexa entered into an agreement to issue to 10.0 million shares of common stock at $6.50 per share and five-year warrants to purchase approximately 3.5 million shares of common stock at an exercise price of $7.50 per share. On November 23, 2005, pursuant to the agreement, Solexa issued approximately 3.9 million shares of common stock and warrants to purchase approximately 1.3 million shares of common stock, receiving net proceeds of $23.3 million. Following receipt of stockholder approval, Solexa issued on January 19, 2006 approximately 6.1 million shares of common stock and warrants to purchase approximately 2.2 million shares of common stock, receiving net proceeds of approximately $37.8 million. In aggregate, Solexa raised a total of approximately $61.1 million, net of issuance costs, related to this purchase agreement.

In January 2006, the Company issued 13,042 shares of common stock from the 2005 Equity Incentive Plan to members of the Board of Directors in lieu of board fees accrued. The related expense had been recognized in 2005 in the approximate amount of $140,000.

In January 2006, the Company issued 24,580 shares of common stock to Silicon Valley Bank in a net exercise of warrants to purchase 59,999 shares of common stock. No proceeds were received by the Company as a result of this net exercise.

During the six months ended June 30, 2006, the Company issued 251,861 shares of common stock for total cash consideration of $1,260,000 from the exercise of warrants.

During the six months ended June 30, 2006, the Company issued 35,510 shares of common stock for total cash consideration of $214,000 from the exercise of employee stock options.

10. Goodwill and Intangible Assets

Goodwill is not being amortized but is tested for impairment annually, as well as when an event or circumstance occurs indicating a possible impairment in value.

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Intangible assets consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Purchased technology	$ 4,254	$ 4,143
Accumulated amortization	(916)	(633)
Intangible assets, net	$ 3,338	$ 3,510

All intangible assets are being amortized using a straight-line method over their estimated useful lives. Purchased technologies have been assigned useful lives of between 7 and 10 years (with a weighted average remaining life of approximately 7.1 years). Amortization expense related to identifiable intangible assets for the six months ended June 30, 2006 and 2005 was approximately $254,000 and $215,000, respectively.

Estimated future amortization expense of intangible assets is as follows (in thousands):

2006 (Remaining 6 months)	$ 256
2007	512
2008	512
2009	512
2010	512
Thereafter	1,034
	$ 3,338

11. Income Tax Benefit

We maintained a full valuation allowance on our deferred tax assets as of June 30, 2006. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS No. 109), which requires an assessment of both positive and negative evidence of possible sources of taxable income and then a determination of whether it is more likely than not that deferred tax assets are recoverable. This assessment is required on a jurisdiction by jurisdiction basis. Cumulative losses incurred by us in recent years represented sufficient negative evidence under SFAS No. 109, and, accordingly, a full valuation allowance was recorded against deferred tax assets. We intend to maintain a full valuation allowance on the deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance.

Our tax benefit was $438,000 and $849,000 for the three months and six months ended June 30, 2006, compared to zero for the three months and six months ended June 30, 2005. This tax benefit results from our estimate of those portions of the annual refundable research credits for 2006 allowed by the United Kingdom Inland Revenue which are attributable to the three months and six months ended June 30, 2006, respectively.

12. Pension Plans

We operate a defined contribution group personal pension plan for substantially all of our United Kingdom employees and a 401(k) Plan, also a defined contribution plan for the employees in the Unites States. Pursuant to the 401(k) Plan, employees in the United States may elect to reduce their current compensation by up to 50% (subject to an annual limit prescribed by the Internal Revenue Code) and have the amount of such reduction contributed to the 401(k) Plan. The 401(k) Plan permits, but does not require, additional contributions to the 401(k) Plan by us on behalf of all participants in the 401(k) Plan. Company contributions to the plans totaled $112,000 and $245,000 for the three months and six months ended June 30, 2006 and $115,000 and $215,000 for the three months and six months ended June 30, 2005, respectively.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and our 2005 audited financial statements and notes thereto included in our Form 10-K filed on March 31, 2006.

Operating results for the three months and six months ended June 30, 2006 are not necessarily indicative of results that may occur in future periods.

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. When used herein, the words believe, anticipate, expect, estimate ar similar expressions are intended to identify such forward-looking statements. There can be no assurance that these statements will prove to be correct. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors which are difficult to forecast and can materially affect our quarterly or annual operating results. Please see Part II. Item 1A Risk factors . We undertake no obligation to update any of the forward-looking statements contained herein to reflect any future events or developments.

Overview

We are in the business of developing and commercializing genetic analysis technologies. We currently generate service revenues in our genomics services business from processing biological samples supplied to us by customers using our MPSS technology. We intend to discontinue providing MPSS services in 2006. We are currently developing and commercializing the Solexa Genome Analysis System, which performs DNA sequencing based on our proprietary reversible-terminator Sequencing-by-Synthesis, or SBS, chemistry and our Clonal Single Molecule Array technology. This instrument platform is expected to perform a range of analyses, including whole genome resequencing, gene expression analysis and small RNA analysis. We believe that this technology, which can potentially generate over a billion bases of DNA sequence from a single experiment with a single sample preparation, will dramatically reduce the cost, and improve the practicality, of human resequencing relative to conventional technologies. We expect our first-generation instrument, the 1G Genome Analyzer, to enable human genome resequencing below $100,000 per sample, which would make it the first platform to reach this important milestone. We commenced commercial shipment of our first generation system, including the 1G Genome Analyzer, in the second quarter of 2006. Our longer-term goal is to further reduce the cost of resequencing a human genome to a few thousand dollars for use in a wide range of applications from basic research through clinical diagnostics.

On March 4, 2005, Solexa Limited, a privately held United Kingdom company, and Lynx Therapeutics, Inc., a Delaware corporation, completed a business combination. Solexa Limited became a wholly-owned subsidiary of Lynx as a result of the transaction, and Lynx changed its name to Solexa, Inc. However, because immediately following the business combination transaction the former Solexa Limited shareholders owned approximately 80% of the shares of the common stock of Lynx, Solexa Limited s designees to the combined company s board of directors represented a majority of the combined company s directors and Solexa Limited s senior management represented a majority of the senior management of the combined company, Solexa Limited was deemed to be the acquiring company for accounting purposes. Accordingly, the assets and liabilities of Lynx were recorded, as of the date of the business combination, at their respective fair values and added to those of Solexa Limited. The results of operations of the combined company for 2005 reflect those of Solexa Limited, to which the results of operations of Lynx were added from the date of the consummation of the business combination. The results of operations of the combined company reflect purchase accounting adjustments, including increased amortization and depreciation expense for acquired assets.

In connection with this business combination transaction, Lynx changed its name to Solexa, Inc. and its trading symbol to SLXA. Unless specifically noted otherwise, as used throughout these Consolidated Financial Statements, Lynx Therapeutics or Lynx refers to the business, operations and financial results of Lynx Therapeutics, Inc. prior to the business combination consummated on

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March 4, 2005, Solexa Limited refers to the business of Solexa Limited, a privately held United Kingdom company prior to the business combination, Solexa refers to the business of the combined company after the business combination, and we refers to either the business operations and financial results of Solexa Limited prior to the business combination or the business of the combined company after the business combination, as the context requires.

As of June 30, 2006, we had an accumulated deficit of approximately $71.0 million. We expect to continue to incur net losses as we proceed with the commercialization and development of our technologies. The size of these losses will depend on the rate of growth, if any, in our revenues and on the level of our expenses. Our cash and cash equivalents have increased from $38.4 million as of December 31, 2005 to $58.1 million as of June 30, 2006, due to financing activities involving a private placement of shares of our common stock and warrants to purchase our common stock and warrant exercises, partially offset by cash used in operations.

On November 18, 2005, we entered into a definitive agreement for a private placement of common stock and warrants to purchase common stock that raised approximately $23.3 million, net of expenses, in the fourth quarter of 2005. On January 19, 2006, we received the balance of net proceeds of approximately $37.8 million pursuant to this agreement. In aggregate, we raised a total of approximately $61.1 million net of issuance costs in connection with the two closings of the private placement.

Prior to the business combination with Lynx, Solexa Limited was a development stage company with minimal revenue. As a result of the business combination, Solexa is no longer a development stage company. While we anticipate that sales of the Solexa Genome Analysis System will become our primary revenue source, our genomics services business based on MPSS technology, which had previously been conducted by Lynx Therapeutics, has to date constituted our primary revenue source. Lynx historically received, and we expect to continue to receive in the future, a significant portion of our genomics services revenues from a small number of customers. We intend to discontinue services based on MPSS in 2006 and are in the process of renegotiating our current MPSS customer contracts in order to provide these customers with services based on our SBS chemistry. We also expect to receive a significant portion of our product revenue from a small number of customers in the early stages of commercialization of our Solexa Genome Analysis System.

Revenues from the genomics services business in each quarterly period have in the past, and could in the future, fluctuate due to: the level of service fees, which is tied to the price, number and timing of biological samples received from our customers, as well as our performance of the related genomics services on the samples; the timing and amount of any technology access fees and the period over which the revenue is recognized; the number, type and timing of new, and the termination of existing, agreements with customers; and the sale of instruments, reagents and other consumables, if any. In addition, our plans to introduce genomics services based on our next-generation technology and to discontinue MPSS-based services could adversely impact our genomics services revenues.

We have not yet begun to recognize revenue on the sale of our genetic analysis system. We anticipate that systems revenues will fluctuate due to a number of factors, including: the level and timing of sales of instruments, reagents and other consumables and service contracts; the timing and ability of Solexa to manufacture or procure these items; the pricing and technical performance levels of our products; the existence of competing genetic analysis systems; and revenue recognition policies.

Our operating costs and expenses include cost of service revenue, manufacturing start up costs, research and development expenses, sales, general and administrative expenses and restructuring expense. Cost of service revenue includes primarily, the cost of direct labor, materials and supplies, outside expenses, equipment and overhead including instrument depreciation, as well as period spending on work-in-process samples that exceeds the expected revenue for those samples. Cost of service revenue for the three months and six months ended June 30, 2006 excludes amounts charged to a forward loss contingency that we established in the third quarter of 2005, of which $28,000 and $1.0 million remained outstanding at June 30, 2006 and December 31, 2005, respectively. We did not incur cost of service revenue until completion of the business combination transaction between Lynx and Solexa Limited.

Manufacturing start-up costs primarily include excess direct labor, excess supplies, outside expenses and excess overhead associated with production of the 1G Genome Analyzer and related consumables.

Research and development expenses include the cost of personnel, materials and supplies, outside expenses, equipment and overhead incurred by us in research and development related to our genetic analysis instrument systems and process development and significant product improvements related to our genomics services business, and stock based compensation. Research and

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development expenses are expected to increase due to spending for ongoing technology development and implementation, including hiring additional personnel and consumption of flow cells and reagents for internal use in research and development.

Sales, general and administrative expenses include the cost of personnel, materials and supplies, outside expenses, equipment and overhead incurred by us primarily in our administrative, sales and marketing, legal and investor relations activities, and stock based compensation. Sales, general and administrative expenses are expected to increase in support of our research and development and commercial efforts, notably personnel, personnel-related and other expenses related to the hiring and operation of a field operations group including personnel focused on sales, field service and field application support.

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements in conformity with US generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. The items in our financial statements requiring significant estimates and judgments include determining the useful lives of fixed assets for depreciation and amortization calculations, determining the fair value of goodwill and intangibles for impairment considerations, assumptions for valuing options and warrants, estimates of future losses for contracts in our genomics services business and assumptions for tax credits that we can claim for research and development activities. Actual results could differ materially from these estimates.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes that other than the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R), there have been no significant changes during the six months ended June 30, 2006 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Revenue

Revenues are related principally to services that we perform on biological samples we receive from our customers. We recognize revenue when persuasive evidence of an arrangement exists, services have been rendered and materials are delivered, the fee is fixed or determinable, and collectibility is reasonably assured. Should conditions cause management to determine that these criteria have not yet been met, then any amounts billed to the customer are recorded as deferred revenue.

Forward Loss Contingency

In our genomics services business, we enter into service contracts to provide genetic analyses on samples provided to us by customers. If management considers it probable that performance on the contract will result in a loss and this loss can be reasonably estimated, a loss reserve is recorded. Management makes estimates of the costs to complete the applicable genetic analyses based on historical experience; expectations of the nature and volume of future samples; the proportion of fixed and variable costs; expectations with respect to production capacity, yields and efficiency in our genomics services business; expectations with respect to the timing and expense of implementing our next-generation technology in our genomics services business; the expected rate of adoption by current customers of our next-generation technology in lieu of MPSS to perform genetic analyses on their biological samples; and expectations of genomic services business sample volume as a whole, including both MPSS and our next-generation technology. If our assumptions or conditions change, the forward loss contingency will be adjusted accordingly.

Inventory

Inventory is stated at the lower of cost (which approximates first-in, first-out cost) or market. The balance at June 30, 2006 was classified as raw materials and work in process. Raw material inventories consist of reagents and other chemicals utilized while performing genomics services and components used to produce our 1G Genome Analyzer and related consumables. Work-in-process inventories consist of the accumulated cost of experiments not completed and subassemblies for our 1G Genome Analyzer and related consumables. Amounts in excess of the service inventory s net realizable value are charged to cost of service revenue or to the forward loss contingency

reserve, as appropriate. Inventory used in providing genomics services and for reagent sales is charged to cost of service revenue when the related revenue is recognized. Inventory used in producing instruments and consumables is charged to deferred cost of goods sold when the products are sold and to cost of goods when the related revenue is recognized. Instrument components, reagents, chemicals and flow cells purchased for internal development purposes are charged to research and development expenses upon receipt or as consumed.

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Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net tangible and identifiable intangible assets acquired in the business combination. Other intangibles including patents, acquired technology rights and developed technology are being amortized using the straight-line method over estimated useful lives of seven to ten years.

Goodwill is not amortized. We review goodwill for impairment annually (or more frequently if impairment indicators exist). We review other intangible assets for impairment when indicators of impairment exist.

The determination of net carrying value of goodwill and intangible assets and the extent to which, if any, there is impairment are dependent upon material estimates and judgements on our part, including the useful life over which the intangible assets are to be amortized, and the estimates of the value of future net cash flows, which are based upon further estimates of future revenues, expenses and operating margins.

Stock-based Employee Compensation

Commencing January 1, 2006, we adopted the provisions of SFAS No. 123R, Share-Based Payment , which required us to expense the fair value of grants made under our equity incentive plans over the requisite service period. We adopted the Modified Prospective Application transition method, which does not result in the restatement of previously issued financial statements. Awards that were granted after January 1, 2006 were measured and non-cash employee compensation expenses were recognized in the condensed consolidated statements of operations in accordance with SFAS No. 123R. In addition, the non-vested portion of awards as of January 1, 2006 also resulted in recognition of non-cash employee compensation expense. We recognize share-based employee compensation expense ratably over the vesting period of options, adjusted for the expected forfeiture rate.

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123R. SFAS 123R requires the use of subjective assumptions, including the options expected life and the price volatility of the underlying stock. The expected volatility is based on the Company s trading activity since the business combination and that of comparable companies in our industry.

For the three months and six months ended June 30, 2006, in accordance with SFAS 123R, the Company recognized non-cash stock-based employee compensation expenses of $952,000 and $1.8 million, respectively. Both basic and diluted loss per share for the three months and six months ended June 30, 2006 where $0.03 and $0.05 higher, respectively, than if the Company had not adopted SFAS 123R and continued to account for stock-based compensation under APB 25. Stock-based employee compensation costs capitalized into inventory and charged against the forward loss contingency were $5,000 and $6,000, respectively for the three months ended June 30, 2006 and $12,000 and $13,000, respectively, for the six months ended June 30, 2006. The operating expenses discussed above include the following allocations of share-based compensation expense for the three months and six months ended June 30, 2006 (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Manufacturing start up costs	$ 25	$ 25
Cost of service revenue	7	13
Research and development	359	674
Sales, general and administrative	561	1,086
Non-cash stock-based employee compensation expense	$ 952	$ 1,798

Recent Accounting Pronouncements

FASB Staff Position No. 123(R)-3 In November 2005, the FASB issued FASB Staff Position No. 123(R)-3 (FSP FAS 123(R)-3), Transition Election to Accounting for Tax Effects of Share-Based Payment Awards. This pronouncement provides an alternative method of calculating the excess tax benefits available to absorb any tax deficiencies recognized subsequent to the adoption of SFAS 123R. We have until November 2006 to make a one-time

election to adopt the transition method. We are currently evaluating FSP FAS 123(R)-3 and whether to make this election. This one-time election will not affect operating loss or net loss.

In June 2006, the FASB issued FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes*. FIN 48 provides interpretive guidance for recognition and measurement of tax positions taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are reviewing the impact of FIN 48, but do not expect the adoption of FIN 48 to have a material impact on our consolidated financial statements.

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In November, 2004, the FASB issued SFAS No. 151, Inventory Costs An Amendment to ARB No. 43, Chapter 4 . SFAS No. 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing , to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that other items such as abnormal freight, handling costs and amounts of wasted materials (spoilage) require treatment as current period charges rather than as a portion of the inventory cost regardless of whether they meet the criterion of so abnormal as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005, and has become applicable to the Company in the second quarter of fiscal 2006 with the commencement of commercial production of the Solexa Genome Analysis System.

Results of Operations

Revenues

Service Revenue. Service revenues for the three months and six months ended June 30, 2006 were approximately $963,000 and $1.7 million, respectively. Service revenues for the three months and six months ended June 30, 2005 were approximately $1.4 million and $2.0 million, respectively. The decreases in revenue for the three months and six months ended June 30, 2006 compared to the same periods in 2005 were primarily due to a decrease in our genomics service business subsequent to the announcement of our conversion to our next generation technology and a windup of our contracts based on MPSS technology. The six months ended June 30, 2005 included only service revenue associated with the MPSS business that we obtained in the business combination and therefore only for the period from March 5, 2005 through June 30, 2005. We have experienced variability from period to period in revenues attributable to our genomics services business based in part on the timing of receipt of biological samples, variability in outstanding contracts and the presence of non-service fee revenues, including sales of reagents and other consumables. We expect this variability as well as additional variability attributable to product mix and pricing, to continue through 2006 and beyond, including after we complete the transition to our next-generation technology in our genomics services business.

During the remainder of 2006, we anticipate beginning to perform genomics services using our SBS reversible terminator chemistry and Clonal Single Molecule Array technology and ceasing to perform MPSS experiments for customers. Our contract with E.I. du Pont de Nemours and Company has been amended to reduce the remaining maximum amount payable to Solexa to $1.5 million, of which a portion is related to the delivery of an instrument and related consumables and the balance to genomics services to be performed under the agreement. Our revenues could vary in 2006 and beyond due to interruptions in genomics services production until the new instrumentation is ready to be deployed in our genomics services business and as the new instrumentation is brought on line as well as due to variable customer demand until the new technology has demonstrated equivalence or superiority to the MPSS technology.

Other Revenue. Other revenue for the three months and six months ended June 30, 2006 was approximately $134,000 and results from initial performance on a government grant contract. There was no similar revenue for the three months or six months ended June 30, 2005.

Operating Costs and Expenses

Total operating costs and expenses were approximately $11.9 million and $23.0 million for the three months and six months ended June 30, 2006, respectively, compared to $10.9 million and $16.7 million for the three months and six months ended June 30, 2005, respectively. The increase in operating costs and expenses for the six months ended June 30, 2006 over the same period for 2005 is due primarily to increased operating costs following the business combination between Lynx and Solexa Limited, product manufacturing start up costs, the expensing of stock-based compensation under SFAS 123R, increased material costs for research and development, including the construction of a number of instruments for internal use, and increased professional fees for SEC reporting and compliance partially offset by the absence of costs incurred in 2005 related to execution of the business combination and the restructuring. The six months ended June 30, 2005 included operating costs and expenses associated with the operations of Lynx that we acquired in the business combination only from March 5, 2005 through June 30, 2005. The increase in operating costs and expenses for the three months ended June 30, 2006 over the same period in 2005 is due primarily

to product manufacturing start up costs, the expensing of stock-based compensation under SFAS 123R and increased research and development spending partially offset by the absence of costs incurred in 2005 related to the execution of the business combination and the restructuring.

Cost of Service Revenue. Cost of service revenue primarily reflects the cost of providing our genomics services, including a reserve for future loss contingencies, direct labor, materials and supplies, outside expenses, equipment and overhead, including instrument depreciation. In addition, we include in cost of service revenue period spending on work-in-process samples that exceeds the expected revenue for those samples. For the three months and six months ended June 30, 2006, cost of service fees were $917,000 and $1.8 million, respectively, compared to $1.7 million and $2.3 million for the three months and six months ended June 30, 2005, respectively. The decreases in cost of service revenue for the three months and six months ended June 30, 2006 compared to the same periods for 2005 were primarily due to a decrease in our genomics service business and costs charged against the forward loss contingency previously provided. The six months ended June 30, 2005 included cost of service revenue only associated with the MPSS business that we obtained in our business combination and therefore only for the period from March 5, 2005 through June 30, 2005.

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Cost of service revenue is net of amounts charged to a future loss contingency that we recorded in the third quarter of 2005 for future loss contingencies with respect to existing service fee contracts. At June 30, 2006, the forward loss contingency which remained on the balance sheet was $28,000. We update this reserve based on an evaluation of contracts with samples performed at a loss; an assessment of our future obligations under these contracts; and a range of forecast assumptions for our future performance of these obligations, including but not limited to the timing of sample receipt, genomics services business sample volume as a whole, our plans to cease operation of our MPSS technology and to deploy our next-generation technology, and operating efficiencies.

Manufacturing Start Up Costs. For the three months and six months ended June 30, 2006 manufacturing start up costs were approximately $724,000. There were no similar costs for the three months and six months ended June 30, 2005. Manufacturing start up costs for the three months and six months ended June 30, 2006 included excess direct labor, excess supplies and outside expenses and excess overhead. We began commercial shipments of the Solexa Genome Analysis System in the second quarter of 2006, but the product cost was deferred until the related revenue is recognized. We expect manufacturing costs and product revenue to increase in the future as we ramp up the manufacturing of our next-generation instrument and associated consumables. These costs will include personnel, materials and overhead. This ramp up of production activities will take place both in the US and the UK in the second half of 2006.

Research and Development Expenses. Research and development expenses were approximately $5.5 million and $11.8 million for the three months and six months ended June 30, 2006, respectively, compared to $4.7 million and $7.6 million for the three months and six months ended June 30, 2005, respectively. The $832,000 increase in research and development expenses for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily due to increases in personnel and related expenses due to the hiring of additional permanent and temporary employees, charges for stock based compensation, increases in material expenses, including the production and operation of multiple prototype instruments for use in research and significant product development. The $4.2 million increase in research and development expenses for the six months ended June 30, 2006 versus the six months ended June 30, 2005 was primarily due to increased operating costs following the business combination on March 4, 2005, increases in material expenses related to instrument prototypes, increases in personnel and related expenses, and charges for stock based compensation.

We expect research and development expenses to increase in the future as we continue product development efforts for our next-generation genetic analysis instrument system, build and operate additional instruments for internal R&D projects, including our plan to sequence a human genome in 2006, and build out additional leasehold improvements.

We cannot reasonably estimate the timing and costs of our research and development programs due to the risks and uncertainties associated with developing a novel genetic analysis instrument system and subsequent improvements. We expect that there will be significant additional work required to optimize the instrument and consumable portions of the system to achieve target performance levels even after we begin to ship and recognize revenue on the sale of our next-generation instrument system. Furthermore, we anticipate continued spending on research and development related to future-generation systems and to additional applications of our genetic analysis instrument systems.

Sales, General and Administrative Expenses. Sales, general and administrative expenses were approximately $4.8 million and $8.6 million for the three months and six months ended June 30, 2006, respectively, compared to $4.1 million and $6.5 million for the three months and six months ended June 30, 2005, respectively. The increase of $667,000 in sales, general and administrative spending for the three months ended June 30, 2006 compared to the same period for 2005 was primarily due to increased personnel and related expenses; increased professional fees related to SEC compliance; and charges for stock-based compensation. The increase of $2.1 million in sales, general and administrative spending for the six months ended June 30, 2006 compared to the same period for 2005 was primarily due to increased operating costs following the business combination due both to the business combination and to subsequent recruiting, including increased personnel and related expenses; increased professional fees related to SEC compliance; and charges for stock-based compensation, partially offset by the absence of costs related to consummation of the business combination transaction.

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We expect sales, general and administrative expense to increase in the near future as we hire additional personnel to support the commercialization of our next-generation genetic analysis instrument system and to increase non-personnel sales and marketing spending, including but not limited to promotional materials and activities, market research, travel and training. We expect to hire additional sales and marketing personnel, including salespeople, application specialists and field service and customer service/technical support personnel.

Restructuring Charge. There was no restructuring charge for the three months and six months ended June 30, 2006 compared to $333,000 for the three months and six months ended June 30, 2005. The 2005 restructuring charge included severance and benefit costs from a workforce reduction.

Interest Income

Interest income for the three months and six months ended June, 2006 was $699,000 and $1.4 million, respectively, compared to $91,000 and $227,000 for the three months and six months ended June 30, 2005, respectively. The increase in interest income for the three months and six months ended June 30, 2006 compared to the same periods for 2005 was primarily due to increased amounts of cash and cash equivalents as a result of sales of our common stock in private placement transactions, as well as the increase in interest rates period over period.

Interest Expense

Interest expense was approximately $161,000 and $317,000 for the three months and six months ended June 30, 2006, respectively, compared to $432,000 and $564,000 for the three months and six months ended June 30, 2005, respectively. Interest expense is related principally to the business combination, including the assumption of an idle facility that had been written off prior to the business combination and for which a portion of the rental payments are treated as interest expense and, in 2005, the assumption of $3.0 million of Lynx s note obligations.

Income Tax Benefit

We maintained a full valuation allowance on our deferred tax assets as of June 30, 2006. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS No. 109), which requires an assessment of both positive and negative evidence of possible sources of taxable income and then a determination of whether it is more likely than not that deferred tax assets are recoverable. This assessment is required on a jurisdiction by jurisdiction basis. Cumulative losses incurred by us in recent years represented sufficient negative evidence under SFAS No. 109, and, accordingly, a full valuation allowance was recorded against deferred tax assets. We intend to maintain a full valuation allowance on the deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance.

Our tax benefit was approximately $438,000 and $849,000 for the three months and six months ended June 30, 2006, respectively, compared to zero for the three months and six months ended June 30, 2005. This tax benefit results from our estimate of that portion of the annual refundable research credits for 2006 allowed by the United Kingdom Inland Revenue which is attributable to the three months and six months ended June 30, 2006.

Liquidity and Capital Resources

Cash and cash equivalents increased from approximately $38.4 million as of December 31, 2005 to approximately $58.1 million as of June 30, 2006.

Operating Activities. Net cash used in operating activities was approximately $19.0 million for the six months ended June 30, 2006 as compared to $13.1 million for the six months ended June 30, 2005. The increase in cash used in operating activities resulted primarily from an increase in our net loss, an increase in our inventory in preparation for shipping our next-generation genetic analysis instrument systems and an increase in our UK tax receivable which are partially offset by increases in stock-based compensation expense.

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Investing Activities. Net cash used in investing activities was approximately $1.4 million for the six months ended June 30, 2006, compared to $1.5 million for the six months ended June 30, 2005. Decreased net cash used in investing activities was primarily due to the absence of cash expenses incurred in the business combination, partially offset by an increase in purchases of property and equipment.

Financing Activities. Net cash provided by financing activities was approximately $39.3 million for the six months ended June 30, 2006, compared to net cash provided by financing activities of $8.2 million for the six months ended June 30, 2005. Net cash provided by financing activities in the six months ended June 30, 2006 consisted of $37.8 million received pursuant to a private placement of common stock and warrants to purchase common stock, net of related financing costs, and proceeds from the exercise of stock options and warrants. Net cash from financing activities of $8.2 million for the six months ended June 30, 2005 consisted of funds received pursuant to a private placement of common stock, net of financing cost; the proceeds of stock options and the proceeds from the sale and leaseback of equipment.

On November 18, 2005, we entered into an agreement to issue to private investors 10.0 million shares of common stock at $6.50 per share and five-year warrants to purchase approximately 3.5 million shares of common stock at an exercise price of $7.50 per share. On November 23, 2005, pursuant to the agreement, we issued approximately 3.9 million shares of common stock and warrants to purchase approximately 1.3 million shares of common stock, receiving net proceeds of $23.3 million. Upon receipt of stockholder approval, we issued on January 19, 2006 approximately 6.1 million shares of common stock and warrants to purchase approximately 2.2 million shares of common stock, receiving net proceeds of approximately $37.8 million. In aggregate, we received a total of approximately $61.1 million, net of issuance costs.

Operating Capital Requirements. We plan to use available funds for ongoing commercial, research and development and related sales, general and administrative activities, working capital, capital expenditures and other general corporate purposes. We expect our capital investments during 2006 to be approximately $3.0 million and to consist primarily of expenditures for capital equipment required in the normal course of business, for the introduction of our Solexa Genome Analysis System and for leasehold improvements.

We have obtained funding for our operations primarily through sales of common stock, ordinary shares and preferred shares, payments received under contractual arrangements with customers, proceeds from the exercise of stock options and warrants and interest income. Consequently, investors in our equity securities and our customers are significant sources of liquidity for us. Therefore, our ability to maintain liquidity is dependent upon a number of uncertain factors, including but not limited to the following: our ability to advance and commercialize further our new technologies; our ability to generate revenues through expanding and converting existing customer arrangements to our new technologies and obtaining significant new customers either in our genomics services business or through the sale of our instruments and consumables related to the Solexa Genome Analysis System, and the receptivity of capital markets toward our equity or debt securities. The cost, timing and amount of funds required by us for specific uses cannot be precisely determined at this time and will be based upon the progress and the scope of our commercial and research and development activities; payments received under customer agreements; our ability to establish and maintain customer agreements; costs of protecting intellectual property rights; legal and administrative costs; additional facilities capacity needs; and the availability of various methods of financing.

Solexa Limited incurred net losses each year since its inception in 1998 through March 4, 2005, the date on which the business combination transaction with Lynx was consummated, and we have continued to incur net losses since that time. As of June 30, 2006, we had an accumulated deficit of $71.0 million. Net losses may continue for the next several years as we proceed with the development and commercialization of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses.

We believe that our cash balances at June 30, 2006 will be sufficient to meet our projected working capital and other cash requirements through at least the next twelve months. However, there can be no assurance that future events will not require us to seek additional borrowings or capital and, if so required, that such borrowing or capital will be available on acceptable terms.

Off-Balance Sheet Arrangements. At June 30, 2006 and December 31, 2005, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Financial Risk Management

We are exposed to various market risks, including changes in foreign currency exchange rates. Our United Kingdom subsidiary s assets are held in the U.K. pound, its functional currency. Its accounts are translated from the U.K. pound to the U.S. dollar using the current exchange rate in effect at the balance sheet date, for most balance sheet accounts excluding principally certain intercompany and equity accounts, and using the average exchange rate during the period, for revenues and expense accounts. Additionally, approximately 11% of our revenue for the six months ended June 30, 2006 was from foreign countries. All of our sales are denominated in U.S. dollars or U.K. pounds. As a result, we are exposed to risks associated with foreign exchange rate fluctuations. To date, we have not taken any action to reduce our exposure to changes in foreign currency exchange rates, such as options or futures contracts, with respect to transactions between our subsidiary and us.

The primary objective of our investment activities is to preserve principal while, at the same time, maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high-quality debt securities. Our investments in debt securities are subject to interest rate risk. To minimize the exposure due to adverse shifts in interest rates, we invest in short-term securities and maintain an average maturity of less than one year. As a result, we do not believe we are subject to significant interest rate risk.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Based on their evaluation as of June 30, 2006, our Chief Executive Officer and Vice President and Chief Financial Officer have concluded that, as a result of the material weakness discussed below, 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) were not effective in providing reasonable assurance that the information required to be disclosed by us in this report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and Form 10-Q.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As of June 30, 2006, management has determined a material weakness exists in our ability to maintain effective controls over the application of generally accepted accounting principles (GAAP) related to the financial reporting process. We currently have limited financial personnel and they do not possess sufficient depth, skills and experience to ensure that all transactions are accounted for in accordance with GAAP. Additionally, we have insufficient formalized procedures to assure that transactions receive adequate review by accounting personnel with sufficient technical accounting expertise.

The ineffective control over the application of GAAP related to the financial reporting process could result in a material misstatement to our annual or interim financial statements that may not be prevented or detected. As a result, management has determined that this control deficiency constituted a material weakness in internal controls over financial reporting as of June 30, 2006.

Changes in Internal Controls over Financial Reporting

We have hired a Senior Director of Finance in June 2006 and a US Controller in July 2006 and are recruiting additional finance and accounting personnel to fill multiple open positions in our finance organization. During the first quarter of 2006, we implemented a new companywide automated accounting system. During the second quarter of 2006 we have contracted for additional temporary and consulting personnel resources.

Except as discussed above, there were no changes in our internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Limitations on the Effectiveness of Controls

Our management, including our Chief Executive Officer and Vice President and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake.

Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings.

We are not a party to any material legal proceedings.

Item 1A. Risk Factors.

Our business faces significant risks. These risks include those described below and may include additional risks of which we are not currently aware or which we currently do not believe are material. If any of the events or circumstances described in the following risks actually occurs, our business, financial condition or results of operations could be harmed. These risks should be read in conjunction with the other information set forth in this report.

We have a history of net losses, expect to continue to incur net losses and may not achieve or maintain profitability.

We have incurred net losses each year since our inception, including a net loss for the six months ended June 30, 2006. As of June 30, 2006, we had an accumulated deficit of approximately $71.0 million. Net losses may continue for the next several years as we proceed with the development and commercialization of our technologies, including the Solexa Genome Analysis System. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, or decline in revenues and on the level of expenses. Research and development expenditures and sales, general and administrative costs have exceeded revenues to date, and we expect these expenses to increase in the future. We will need to generate significant revenues to achieve profitability, and even if we are successful in achieving profitability, there is no assurance we will be able to sustain profitability.

If we are unable to successfully develop and commercialize our new products, we will not be able to increase our revenues or become profitable.

We set out to develop new DNA sequencing technologies, and we are now using those technologies to develop new genetic analysis instruments, consumables and services, and we have begun commercial shipments to a limited number of customers. If our strategy does not result in the development of products, including our 1G Genome Analyzer, that we can commercialize in a timely manner, we will be unable to generate significant revenues. Furthermore, there is no guarantee that we will be able to sell our instruments and consumables in sufficient quantities or on terms that will generate profits or positive cash flow. Although we have developed DNA sequencing instruments that we currently use in providing gene expression services to customers, these instruments are based on the MPSS technology developed by Lynx rather than the new technologies currently under development. We cannot be certain that we will successfully develop any new products, including our 1G Genome Analyzer, in a timely manner, or that the new products will receive commercial acceptance, in which case we may not be able to increase or maintain our revenues or become profitable.

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We have articulated aggressive business and technical objectives for the second half of 2006, including launching a number of applications to be run on the Solexa Genome Analysis System in 2006; making the Solexa Genome Analysis System broadly commercially available in the second half of 2006; deploying the Solexa Genome Analysis System in our genomics services business; and sequencing the human genome in 2006. We will need to overcome significant challenges to achieve these milestones in the designated timeframes, including continuing to improve the technical performance of our system; obtaining customer acceptance of our products; and producing and implementing a number of 1G Genome Analyzers at both our U.K. and California sites. Failure to accomplish these objectives, or to accomplish them within the articulated timeframes, could cause our stock price to decline or to be come more volatile.

Our technology platform is at the development stage and is unproven for market acceptance.

We are discontinuing our MPSS technology, which had been used for certain kinds of genetic analysis, including gene expression and small RNA analysis. We are developing our SBS reversible-terminator chemistry and our Clonal Single Molecule Array technology to perform similar genetic analyses as well as to sequence the DNA of genomes and of individual genes and genomic regions. While we have commenced commercial shipments of our Solexa Genome Analysis System, these technologies are still in development, and we may not be able to move beyond the Early Access phase of our commercialization or to successfully complete development of these technologies or commercialize them. Our success depends on many factors, including:

- technical and economic performance of our technologies in relation to competing technologies;
- acceptance of our technology in the marketplace;
- our ability to establish an instrument manufacturing capability, or obtain instruments from another manufacturer; and
- our ability to manufacture reagents and other consumables, or obtain licenses to resell reagents and other consumables.

You must evaluate us in light of the uncertainties and complexities affecting an early stage genetic analysis systems company. The application of our technologies is at too early a stage to determine whether they can be successfully implemented within our targeted timeframe, for our targeted applications or at our targeted technical and economic performance levels. Our technologies also depend on the successful integration of independent technologies, each of which has its own development risks. We anticipate that, if our technology is able to successfully reduce the cost of genetic analysis relative to existing providers, our technology may be able to displace current technology as well as to expand the market for genetic analysis to include new applications that are not practical with current technology. The current focus of many of our potential customers performing DNA sequencing is on candidate region, candidate gene and *de novo* sequencing, rather than on whole genome resequencing. Furthermore, although we believe our system should be suitable for resequencing large and complex genomes, there is no single technique that can be used to resequence the entire genome of a human. Instead, scientists need to combine several techniques to address complex structures such as long repeat sequences. One example of such a technique is paired-end reads. We anticipate developing over time additional techniques, such as paired-end reads, for use with our system. Our inability to sequence an entire human genome may limit our market.

We expect that a substantial portion of our sales will be to customers at universities or research laboratories the amount and timing of whose funding is dependent on third-party sources.

Many of our potential customers must demonstrate to governmental and other funding sources that our technology has been successfully developed before they can make substantial purchases of our products. There is no guarantee, even if our technology can reduce the cost of genetic analysis relative to existing approaches, that we will be able to induce customers with installed bases of conventional genetic analysis instruments to purchase our system or that we will be able to expand the market for genetic analysis to include new applications. Furthermore, if we are only able to successfully commercialize our genetic analysis systems as a replacement for existing technology, we may face a much smaller market than we currently anticipate.

We have limited experience in sales, marketing and field support and thus may be unable to commercialize our genetic analysis instrument systems and services.

Our ability to achieve profitability depends on attracting customers for our genetic analysis instrument systems and services. There are a limited number of research institutes and pharmaceutical, biotechnology and agricultural companies that are potential customers

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for our products and services. To market and sell our products and services, we intend to develop a sales and marketing group with the appropriate technical expertise. While we have hired an executive to run our field organization and have both made initial hires and transferred existing employees to roles in sales, field application support and field service, we may not successfully build such a field organization. In addition, we may seek to enlist a third party to assist with sales and distribution globally, in certain regions of the world or for certain applications. In addition, if we are successful in achieving market acceptance for our new genetic analysis instruments, we will need either to build internal capabilities to install and maintain instruments at customer sites, to assist customers with the experiments that they intend to conduct using our instruments and to train customers on the use of our instruments, or to contract with one or more partners to do so on our behalf. There is no guarantee, if we do seek to enter into such arrangements, that we will be successful in attracting one or more desirable sales and distribution partners, or that we will be able to enter into such arrangements on favorable terms. If our sales, marketing, field application support and field service efforts, or those of any third-party sales and distribution partner, are not successful, our technologies and products may not gain market acceptance, which could materially impact our business operations. Any delay in establishing or inability to expand our sales, marketing and field support capacity could hurt our business.

We will need to develop manufacturing capacity either by ourselves or with a partner.

If we are successful in achieving market acceptance for our new genetic analysis instruments, we will need either to build increased internal manufacturing capacity for instruments, flow cells and reagents, or to contract with one or more manufacturing partners. While we have begun to hire dedicated manufacturing personnel, including our Chief Operating Officer, who is in charge of manufacturing, we are currently using additional personnel from our research and development and genomics services groups and consultants to address our anticipated manufacturing and outsourcing needs. There is no assurance that we will be able to build manufacturing capacity internally, or to contract with one or more manufacturing partners, in order to meet both the volume and quality requirements necessary to be successful in the market. Any delay in establishing or inability to expand our manufacturing capacity could hurt our business.

Our current business model is unproven and different from our former business model.

Our current business model is based primarily on the planned sales of genetic analysis instruments and of reagents and other consumables and services to support customers in their use of that equipment. Alternative commercial arrangements may take the form of equipment leases, equipment placements and collaborations with customers at academic, government and commercial labs, among others.

Lynx s historical business model, which we have continued since the business combination, was based on providing genomics services using our MPSS technology and supplying customers with DNA sequences and other information that resulted from experiments. A change in emphasis from our former business model has caused some current and prospective customers of our genomics services business to delay, defer or cancel purchasing decisions with respect to new or existing agreements. There is no assurance that we will be successful in changing the emphasis of our business model from providing genomics services to selling instruments, consumables and support services to new or existing customers. We intend to discontinue providing MPSS based services in 2006 and are in the process of renegotiating our current MPSS customer contracts in order to provide those customers with services based on our new SBS technology. We have entered into new or amended agreements with some of our existing customers providing for the transition from MPSS-based services to SBS-based services. There is no guarantee, however, that all of our customers will migrate to the new technology platform once it is commercialized or that our genomics services business will generate positive cash flow or become profitable.

We may need to raise additional funding, which may not be available on favorable terms, if at all.

We may need to raise additional capital through public or private equity or debt financings in order to satisfy our projected future capital needs.

The amount of additional capital we may need to raise depends on many factors, including:

the progress and scope of research and development programs;

the progress of efforts to develop and commercialize new products and services; and

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the costs of preparing, filing, prosecuting, maintaining, defending and enforcing patent claims and other intellectual property rights.

We cannot be certain that additional capital will be available when and as needed or that our actual cash requirements will not be greater than anticipated. If we require additional capital at a time when investment in biotechnology companies or in the marketplace in general is limited due to the then prevailing market or other conditions, we may not be able to raise such funds at the time that we desire or any time thereafter. If we are unable to obtain financing on terms favorable to us, our stockholders may experience significant dilution, we may be unable to execute our business plan, and we may be required to cease or reduce development or commercialization of our products, sell some or all of our technology or assets or merge with another entity.

We currently depend on a small number of customers for substantially all our revenues.

Our strategy for the commercialization of our technologies includes entering into customer agreements in which we provide genomics services to research institutes and pharmaceutical, biotechnology and agricultural companies. Our genomics services business currently generates substantially all of our revenues. After we have developed the Solexa Genome Analysis System, it is our intention to deploy these systems internally over time to replace the MPSS-based instruments currently used in our genomics services business. If we are successful in commercializing our genetic analysis instrument systems, we anticipate continuing to provide genomics services after the commercial launch in order to meet particular customer requirements and to support the marketing of our instruments by, for example, allowing potential systems customers to understand how our instrumentation performs on their samples of interest. We have entered into new or amended agreements with some of our existing customers providing for the transition from MPSS-based services to SBS-based services. There is no guarantee, however, that all of our customers will migrate to the new technology platform once it is commercialized or that our genomics services business will generate positive cash flow or become profitable.

Prior to the business combination with Solexa Limited, Lynx derived substantially all of its revenues from customer agreements, collaborations and licenses related to our genomics services business. Since the business combination we have continued to derive substantially all of our revenues from customer agreements. A significant portion of our revenues comes from a small number of customers. While we have commenced commercial shipments of our new genetic analysis instrument system, we have shipped only to a limited number of customers under an Early Access program, and we have not yet recognized any revenue for the system. Thus, unless and until we are able to more broadly commercialize our new genetic analysis instrument system, we will be dependent on a small number of customers, and the loss of one or more of those customers could harm our results of operations.

Capacity reduction in our genomics services business could increase our losses.

Our genomics services business utilizes proprietary MPSS instruments and information systems. In addition, the MPSS process is lengthy and complex. These instruments, systems and work processes are subject to intermittent failures. Any production stoppages or yield reductions due to these factors or otherwise could reduce the number of samples we are able to process and the revenues we recognize, could delay our intended termination of MPSS activities in 2006 and could increase our losses. While we intend to deploy our novel instrument system in our genomics services business in 2006, any delays or other difficulties in implementing the new technology could reduce the number of samples we are able to process and the revenues we recognize and could increase our loss.

The sales cycle for our genomics services business is lengthy, and we may spend considerable resources on unsuccessful sales efforts or may not be able to enter into agreements on the schedule we anticipate.

Our ability to obtain customers for our technologies and products depends in significant part upon the perception that our technologies and products can help reduce the costs or accelerate the timing of drug discovery and development, diagnostics and genomics efforts. The sales cycle for our genomics services business is typically lengthy, in many cases nine months or more, because we need to educate our potential customers and to sell the benefits of our services to a variety of constituencies within such entities. It is too early to determine the sales cycle for our systems business, which may also be lengthy. In addition, we may be required to negotiate agreements containing terms unique to each customer. We may expend substantial funds and management effort without any assurance that we will successfully sell our technologies and products. Actual and proposed consolidations of pharmaceutical companies have negatively affected, and may negatively affect, the timing and progress of our sales

efforts.

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We operate in an intensely competitive industry with rapidly evolving technologies, and our competitors may develop products and technologies that make ours obsolete.

The biotechnology industry is highly fragmented and is characterized by rapid technological change. In particular, the areas of genetic analysis platforms and genomics research are rapidly evolving fields. Competition among entities developing genetic analysis systems is intense. Many of our competitors have substantially greater research and product development capabilities and financial, scientific and marketing resources than we do.

In our genomics services business, we face, and will continue to face, competition primarily from biotechnology companies, such as Affymetrix, Inc., the Agencourt Biosciences business of Beckman Coulter, Inc., Celera Genomics Group, Gene Logic, Inc., academic and research institutions and government agencies, both in the United States and abroad. Our competitors are using a variety of gene expression analysis methodologies, including chip-based systems, to attempt to identify disease-related genes and to perform clinical diagnostic tests. In addition, a number of companies offer DNA sequencing equipment or consumables, including Applera Corporation, Beckman Coulter, Inc., the Amersham Biosciences business of General Electric and Roche Diagnostics in partnership with 454 Corporation. Furthermore, a number of other companies and academic groups are in the process of developing novel techniques for DNA sequencing. These companies include, among others, Genizon, Genovoxx, Helicos Biosciences, LI-COR, Lucigen, Microchip Biotechnologies, Pacific Biosciences, Perlegen, Shimadzu Biotech and Visigen. A number of companies offer gene expression equipment, including Affymetrix, Inc., Agilent Technologies, Applera Corporation, and Illumina, Inc. In order to successfully compete against existing and future technologies, we will need to demonstrate to potential customers that our technologies and capabilities are superior to those of our competitors.

Our future success will depend on our ability to maintain a competitive position with respect to technological advances. Rapid technological development by others may make our technologies and future products obsolete.

Any products that are developed based on our technologies will compete in highly competitive markets. Competitors may be more effective at using their technologies to develop commercial products than us. Moreover, some of our competitors have, and others may, introduce novel genetic analysis platforms before we do which, if adopted by customers, could eliminate the market for our new genetic analysis systems. Furthermore, our competitors may obtain intellectual property rights that would limit the use of our technologies or the commercialization of diagnostic or therapeutic products using our technologies. As a result, our competitors products or technologies may render our technologies and products obsolete or noncompetitive.

Furthermore, our competitors may combine operations through merger, acquisition, licensing, distribution arrangements, partnerships and other activities. Such arrangements may give our competitors advantages they did not previously have and lead to even more intense competition.

If management is unable to effectively manage the increasing size and complexity of our organization, our operating results will suffer.

Our employees are based in Hayward, California and Cambridge, United Kingdom. We have increased staff substantially since the end of 2005 and we plan to hire additional personnel at both sites. As a result, we face challenges inherent in efficiently managing and coordinating the activities of our increasing number of employees located in different countries, including the need to implement appropriate systems, financial controls, policies, standards, benefits and compliance programs. The inability to successfully manage a growing and internationally diverse organization could hurt our business, and, as a result, the market price of our common stock could decline.

We are subject to risks associated with our international operations which may harm our business.

A significant portion of our research and development and other operations are located in the United Kingdom which subjects us to a number of risks associated with conducting business outside of the United States, including, but not limited to:

fluctuations in currency exchange rates;

imposition of additional taxes and penalties; and

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the burden of complying with foreign laws.

Currently, most of our employment arrangements with our employees and consultants in the United Kingdom and lease agreements for our facilities in Cambridge, United Kingdom provide for payment in British pounds. Increases in the value of the UK pound relative to the United States dollar will increase our expenses related to our operations in the United Kingdom, which could harm our business in the future and reduce the market for our common stock. To date, we have not engaged in any currency hedging activities, although we may do so in the future.

We could lose key personnel, which could materially affect our business and require us to incur substantial costs to recruit replacements for such lost personnel.

Any of our key personnel could terminate their employment with us, sometimes without notice, at any time. John West, our Chief Executive Officer, in particular, is a key member of our management team. We are also highly dependent on the principal members of our scientific and commercial staff. The loss of any of these persons services might adversely impact the achievement of our commercial objectives. In addition, recruiting and retaining qualified scientific personnel to perform future research and development work will be critical to our success. There is currently a shortage of skilled executives and employees with technical expertise in our industry, and this shortage may continue. As a result, competition for skilled personnel is intense, and turnover rates are high. Competition for experienced scientists from numerous companies, academic and other research institutions may limit our ability to attract and retain new or current personnel.

If we fail to adequately protect our proprietary technologies, third parties may be able to use our technologies, which could prevent us from competing in the genomic analysis instrument and genomics services market.

Our success depends in part on our ability to obtain patents and maintain adequate protection of the intellectual property related to our technologies and products. The patent positions of genetic analysis instrument, reagents and other consumables sales and services companies and other biotechnology companies, including us, are generally uncertain and involve complex legal and factual questions. We will be able to protect our proprietary rights from unauthorized use by third parties only to the extent that our proprietary technologies are covered by valid and enforceable patents or are effectively maintained as trade secrets. The laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the U.S., and many companies have encountered significant problems in protecting and defending their proprietary rights in foreign jurisdictions. We have applied and will continue to apply for patents covering our technologies, processes and products, as and when we deem appropriate. However, third parties may challenge these applications, or these applications may fail to result in issued patents. Our existing patents and any future patents we obtain may not be sufficiently broad to prevent others from practicing our technologies or from developing competing products. Furthermore, others may independently develop similar or alternative technologies or design around our patents. In addition, our patents may be challenged or invalidated or fail to provide us with any competitive advantage.

We also rely on trade secret protection for our confidential and proprietary information. However, trade secrets are difficult to protect. We protect our proprietary information and processes, in part, with confidentiality agreements with employees and consultants. However, third parties may breach these agreements, we may not have adequate remedies for any such breach or our trade secrets may still otherwise become known by our competitors. In addition, our competitors may independently develop substantially equivalent proprietary information.

Litigation or third-party claims of intellectual property infringement could require us to spend substantial time and money and adversely affect our ability to develop and commercialize our technologies and products.

Our commercial success depends in part on our ability to avoid infringing patents and proprietary rights of third parties and not breaching any licenses that we have entered into with regard to our technologies. Other parties have filed, and in the future are likely to continue to file, patent applications covering imaging, image analysis, fluid delivery, DNA arrays on solid surfaces, chemical and biological reagents for DNA sequencing, genes, gene fragments, the analysis of gene sequences, gene expression, DNA amplification and the manufacture and use of DNA chips or microarrays, which are tiny glass or silicon wafers on which tens or hundreds of thousands of DNA molecules can be arrayed on the surface for subsequent analysis. If patents covering technologies required by our operations are issued to others, we may have to rely on licenses from third parties, which may not be available on commercially reasonable terms, or at all.

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Third parties may accuse us of employing their proprietary technology without authorization. In addition, third parties may obtain patents that relate to our technologies and claim that use of such technologies infringes these patents. Regardless of their merit, such claims could require us to incur substantial costs, including the diversion of management and technical personnel, in defending ourselves against any such claims or enforcing our patents. In the event that a successful claim of infringement is brought against us, we may need to pay damages and obtain one or more licenses from third parties. We may not be able to obtain these licenses at a reasonable cost, or at all. Defense of any lawsuit or failure to obtain any of these licenses could adversely affect our ability to develop and commercialize our technologies and products and thus prevent us from achieving profitability.

We currently utilize sole-source suppliers for certain components of our Solexa Genome Analysis System and in our MPSS service business.

We anticipate purchasing, on a sole-source basis, certain components for our 1G Genome Analyzer and certain consumables used to operate and prepare samples to be run on the 1G Genome Analyzer. We are in the process of negotiating supply agreements for certain of these sole-source items.

When we rely on sole vendors, we subject our business to several risks, including:

the inability to obtain an adequate supply due to manufacturing capacity constraints, a discontinuation of a product by a third-party manufacturer or other supply constraints;

the potential lack of leverage in contract negotiations with the sole vendor;

reduced control over quality and pricing of components; and

delays and long lead times in receiving materials from vendors.

We believe that we would be able to purchase alternative instrument components and consumables from other providers should the need arise, although we would likely incur additional expense and delay. Such additional expense and delay could be material and could harm our business in the short term.

We use hazardous chemicals and radioactive and biological materials in our business. Any claims relating to improper handling, storage or disposal of these materials could be time consuming and costly.

Our research and development processes involve the controlled use of hazardous materials, including chemicals and radioactive and biological materials. Our operations produce hazardous waste products. We cannot eliminate the risk of accidental contamination or discharge and any resultant injury from these materials. We may be sued for any injury or contamination that results from our use or the use by third parties of these materials, and our liability may exceed our insurance coverage and our total assets. Federal, state and local laws and regulations govern the use, manufacture, storage, handling and disposal of hazardous materials. Compliance with environmental laws and regulations may be expensive, and current or future environmental regulations may impair our research, development and production efforts.

Our facilities in Hayward, California are located near known earthquake fault zones, and the occurrence of an earthquake or other catastrophic disaster could cause damage to our facilities and equipment, which could require us to cease or curtail operations.

Our facilities in Hayward, California are located near known earthquake fault zones and are vulnerable to damage from earthquakes. We are also vulnerable to damage from other types of disasters, including fire, floods, power loss, communications failures and similar events. If any disaster were to occur, our ability to operate our business at our facilities would be seriously, or potentially completely, impaired. In addition, the unique nature of our activities could cause significant delays in our research programs commercial activities and make it difficult for us to recover from a disaster. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Accordingly, an earthquake or other disaster could materially and adversely harm our ability to conduct business.

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Our stock price may be extremely volatile.

We believe that the market price of our common stock will remain highly volatile and may fluctuate significantly due to a number of factors. The market prices for securities of many publicly held, early-stage biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. In addition, the securities markets have from time to time experienced significant price and volume fluctuations that may be unrelated to the operating performance of particular companies. The following factors and events may have a significant and adverse impact on the market price of our common stock:

fluctuations in our operating results;

announcements of technological innovations or new commercial products by us or our competitors;

release of reports by securities analysts;

developments or disputes concerning patent or proprietary rights;

developments in our relationships with current or future customers;

sales of our common stock by large holders, and distributions and/or sales of shares held by stockholders affiliated with certain of our directors; and

general market conditions.

Many of these factors are beyond our control. These factors may cause a decrease in the market price of our common stock, regardless of our operating performance.

We have determined that we have a material weakness in our internal controls over financial reporting. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business and the trading of our stock.

Under Section 302 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effectiveness of our internal controls over financial reporting. As of June 30, 2006, we did not maintain effective control over the application of GAAP related to the financial reporting process. This control deficiency could result in material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constitutes a material weakness. Because of this material weakness, our management concluded that, as of June 30, 2006, we did not maintain effective internal control over financial reporting based on those criteria. Should we, or our independent registered public accounting firm, determine in future fiscal periods that we have additional material weaknesses in our internal controls over financial reporting, the reliability of our financial reports may be impacted, and our results of operations or financial condition may be harmed and the price of our common stock may decline. During the second quarter of 2006, we hired a Senior Director of Finance, and subsequent to the end of the second quarter we replaced a US Controller, who departed Solexa in April 2006.

Our company s officers, directors and their affiliated entities have substantial control over the company.

Our company s executive officers, directors and entities affiliated with them, in the aggregate, as of July 14, 2006 beneficially owned 35% of the outstanding common stock of the company, including warrants and options currently exercisable or exercisable within 60 days of July 14, 2006. These stockholders, if acting together, may be able to influence significantly all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other changes in corporate control.

Anti-takeover provisions in our charter documents and under Delaware law may make it more difficult to acquire us or to effect a change in our management, even though an acquisition or management change may be beneficial to our stockholders.

Under our certificate of incorporation, our board of directors has the authority, without further action by the holders of our common stock, to issue 2,000,000 shares of preferred stock from time to time in series and with

preferences and rights as it may designate. These preferences and rights may be superior to those of the holders of our common stock. For example, the holders of

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preferred stock may be given a preference in payment upon our liquidation or for the payment or accumulation of dividends before any distributions are made to the holders of common stock.

Any authorization or issuance of preferred stock, while providing desirable flexibility in connection with financings, possible acquisitions and other corporate purposes, could also have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock, to remove directors and to effect a change in management. The preferred stock may have other rights, including economic rights senior to those of our common stock, and, as a result, an issuance of additional preferred stock could lower the market value of our common stock. Provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

Item 6. Exhibits.

We incorporate by reference all exhibits filed in connection with our Annual Report on Form 10-K for the year ended December 31, 2005.

Exhibit Number	Description	Incorporated by Reference				Filed Herewith
		Form	File No	Exhibit	Filing Date	
10.37.2	Amendment To Executive Employment Agreement, dated May 19, 2006, by and between Solexa, Inc. and John West.	8-K	000-22570	10.37.2	5/22/2006	
10.39	2005-2006 Bonus Plan, as amended.	8-K	000-22570	10.39	6/13/2006	
10.44	Letter Agreement regarding New Alternative One-Time Bonus Arrangement, dated May 19, 2006, by and between Solexa, Inc. and Linda Rubinstein	8-K	000-22570	10.44	5/22/2006	
10.45	Letter Agreement regarding New Alternative One-Time Bonus Arrangement, dated May 19, 2006, by and between Solexa, Inc. and Peter Lundberg	8-K	000-22570	10.45	5/22/2006	
10.46	Letter Agreement regarding New Alternative One-Time Bonus Arrangement, dated May 19, 2006, by and between Solexa Limited and Tony Smith.	8-K	000-22570	10.46	5/22/2006	
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.					X
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.					X
32.1*						X

Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

+ Portions of this agreement have been deleted pursuant to our request for confidential treatment.

* This certification accompanies the Quarterly Report on Form 10-Q to which it relates, pursuant to Section 906 of the Sarbanes Oxley Act of 2002, and is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Solexa, Inc. under the Securities Act or the Exchange Act (whether made before or after the date of the Quarterly Report on Form 10-Q), irrespective of any general incorporation language contained in such filing.

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SIGNATURES

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

SOLEXA, INC.

By: /s/ John West
John West
Chief Executive Officer
(Principal Executive Officer)

Date: August 14, 2006

By: /s/ Linda Rubinstein
Linda Rubinstein
Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: August 14, 2006

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Exhibit Index

Exhibit Number	Description	Incorporated by Reference				Filed Herewith
		Form	File No	Exhibit	Filing Date	
10.37.2	Amendment To Executive Employment Agreement, dated May 19, 2006, by and between Solexa, Inc. and John West.	8-K	000-22570	10.37.2	5/22/2006	
10.39	2005-2006 Bonus Plan, as amended.	8-K	000-22570	10.39	6/13/2006	
10.44	Letter Agreement regarding New Alternative One-Time Bonus Arrangement, dated May 19, 2006, by and between Solexa, Inc. and Linda Rubinstein	8-K	000-22570	10.44	5/22/2006	
10.45	Letter Agreement regarding New Alternative One-Time Bonus Arrangement, dated May 19, 2006, by and between Solexa, Inc. and Peter Lundberg	8-K	000-22570	10.45	5/22/2006	
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31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.					X
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32.1*	Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).					X

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