Recon Technology, Ltd
Form 10-Q
May 16, 2011

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2011

¨ **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 001-34409

RECON TECHNOLOGY, LTD

(Exact name of registrant as specified in its charter)

Cayman Islands	**Not Applicable**

(State or other jurisdiction of	**(I.R.S. employer**
incorporation or organization)	**identification number)**

Room 1902, Building C, King Long International Mansion

No. 9 Fulin Road, Beijing, 100107

People s Republic of China

(Address of principal executive offices and zip code)

0086-010-84945799

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. The Company is authorized to issue 25,000,000 ordinary shares. As of the date of this report, the Company has issued and outstanding 3,951,811 Shares.

Table of Contents

RECON TECHNOLOGY, LTD

FORM 10-Q

INDEX

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document contains certain statements of a forward-looking nature. Such forward-looking statements, including but not limited to projected growth, trends and strategies, future operating and financial results, financial expectations and current business indicators are based upon current information and expectations and are subject to change based on factors beyond the control of the Company. Forward-looking statements typically are identified by the use of terms such as look, may, should, might, believe, plan, expect, anticipate, estimate and simila although some forward-looking statements are expressed differently. The accuracy of such statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including but not limited to the following:

the timing of the development of future products;

projections of revenue, earnings, capital structure and other financial items;

statements of our plans and objectives;

statements regarding the capabilities of our business operations;

statements of expected future economic performance;

statements regarding competition in our market; and

assumptions underlying statements regarding us or our business.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to update this forward-looking information. Nonetheless, the Company reserves the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this Report. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

See the financial statements following the signature page of this report, which are incorporated herein by reference.

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

The following discussion and analysis of our company s financial condition and results of operations should be read in conjunction with our unaudited consolidated financial statements and the related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. Actual results and the timing of selected events could differ materially from those anticipated in these forward-looking statements as a result of various factors.

Overview

We are a company with limited liability incorporated in 2007 under the laws of the Cayman Islands. Headquartered in Beijing, we provide products and services to oil and gas companies and their affiliates through our contractually controlled affiliates, Beijing BHD Petroleum Technology Co. Ltd (BHD), Nanjing Recon Technology Co., Ltd. (Nanjing Recon), and Jining ENI Energy Technology Co., Ltd. (ENI and, together with BHD and Nanjing Recon, the Domestic Companies). We are the center of strategic management, financial control and human resources allocation for the Domestic Companies.

Through our contractual relationships with the Domestic Companies, we provide equipment, tools and other hardware related to oilfield production and management and develop and sell our own specialized industrial automation control and information solutions. However, we do not engage in the production of petroleum or petroleum products.

Our business is mainly focused on the upstream sectors of the oil and gas industry as shown by the solid framed boxes on the chart below:

We derive our revenues from (1) the sale of hardware products, (2) the sale of software products, and (3) engineering project services. Our products and services involve most of the key procedures of extraction and production of oil and gas, which include automation systems, equipment, tools and on-site technical services. We do not, however, engage in the production of petroleum or petroleum products.

Table of Contents

Service and Products

Our products and services include:

Equipment for Oil and Gas Production and Transportation

High-Efficiency Heating Furnace. Crude petroleum contains certain impurities that must be removed before the petroleum can be sold, including water and natural gas. To remove the impurities and to prevent solidification and blockage in transport pipes, companies employ heating furnaces. BHD researched, developed and implemented a new oilfield furnace that is advanced, highly automated, reliable, easily operable, and comparatively safe and highly heat efficient (90% efficiency).

Burner. We serve as an agent for the Unigas Burner which is designed and manufactured by UNIGAS, a European burning equipment production company. The burner we provide has the following characteristics: high degree of automation; energy conservation; high turn down ratio; high security and is environmentally safe.

Separator. The test separator is the key measurement device for gas and oil in metering plants. Oil and gas mixture sprays on the oil block cap after entering into the separator through the oil pipeline. The diffused oil falls along the pipe wall to the separator bottom and through the draw-off pipe. The gas rises due to its low density and changes the flow direction after concentrating by the separator umbrella. In the process, the small oil droplets in the gas adhere to the umbrella wall and fall along the wall of the pipe. The de-oiled gas enters the pipeline through the freeing pipe at the top of the separator for measurement.

Oil and Gas Development Tools and Equipment

Oil and Gas Production Increasing Techniques:

Packers of Fracturing. This utility model is used concertedly with the security joint, hydraulic anchor, and slide brushing of sand spray in the well. It is used for easy seat sealing and sand-up prevention. The utility model reduces desilting volume and prevents sand-up which makes the deblocking processes easier to realize. The back flushing is sand-stick proof.

Production Packer. At varying withdrawal points, the production packer separates different oil layers, and protects the oil pipe from sand and permeation, promoting the recovery ratio.

Water Injection Packer. The water injection packer injects water into different layers rather than injecting on a large scale; this can reduce cost and promote effectiveness.

Fissure Shaper. This is our proprietary product that is used along with a perforating gun to effectively increase perforation depth by between 46% and 80%, shape stratum fissures, improve stratum diversion capability and, as a result, improve our ability to locate oilfields and increase the output of oil wells.

Sand Prevention in Oil and Water Well. This technique processes additives that are resistant to elevated temperatures into resin sand which is transported to the bottom of the well via carrying fluid. The resin sand goes through the borehole, pilling up and compacting at the borehole and oil vacancy layer. An artificial borehole wall is then formed, functioning as a means of sand prevention. This sand prevention technique has been adapted to more than 100 wells, including heavy oil wells, light oil wells, water wells and gas wells, with a 100% success rate and a 98% effective rate.

Water Locating and Plugging Technique. High water cut affects the normal production of oilfields. Previously, there was no sophisticated method for water locating and tubular column plugging in China. The mechanical water locating and tubular column plugging technique we have developed resolves the problem of high water cut wells. This technique conducts a self-sealing-test during multi-stage usage and is reliable to separate different production sets effectively. The water location switch forms a complete set by which the water locating and plugging can be finished in one trip. The tubular column is adaptable to several oil drilling methods and is available for water locating and plugging in second and third class layers.

Fracture Acidizing. We inject acid to layers under pressure which can form or expand fissures. The treatment process of the acid is defined as fracture acidizing. The technique is mainly adapted to oil and gas wells that are blocked up relatively deeply, or the ones in the zones of low permeability.

Electronic Break-down Service. This service resolves block-up and freezing problems by generating heat from the electric resistivity of the drive pipe and utilizing a loop tank composed of an oil pipe and a drive pipe. This technique saves energy and is environment friendly. It can increase the production of oilfields that are in the middle and later periods.

Automation System and Service:

Pumping Unit Controller. Functions as a monitor to the pumping unit, and also collects data for load, pressure, voltage, startup and shutdown control.

RTU Monitor. Collects gas well pressure data.

Wireless Dynamometer and Wireless Pressure Gauge. These products replace wired technology with cordless displacement sensor technology. They are easy to install and significantly reduce the work load associated with cable laying.

Electric Multi-way Valve for Oilfield Metering Station Flow Control. This multi-way valve is used before the test separator to replace the existing three valve manifolds. It facilitates the electronic control of the connection of the oil lead pipeline with the separator.

Natural Gas Flow Computer System. The flow computer system isused in natural gas stations and gas distribution stations to measure flow.

Recon SCADA Oilfield Monitor and Data Acquisition System. Recon SCADA is a system which applies to the oil well, measurement station, and the union station for supervision and data collection.

EPC Service of Pipeline SCADA System. A service technique for pipeline monitoring and data acquisition after crude oil transmission.

EPC Service of Oil and Gas Wells SCADA System. A service technique for monitoring and data acquisition of oil wells and natural gas wells.

EPC Service of Oilfield Video Surveillance and Control System. A video surveillance technique for controlling the oil and gas wellhead area and the measurement station area.

Technique Service for Digital oilfield Transformation. Includes engineering technique services such as oil and gas SCADA system, video surveillance and control system and communication systems.

Recent Business Developments

Beginning in 2010, the big Chinese oil companies began implementing significant adjustments to their operating strategies. The following strategic initiatives implemented by the large Chinese oil companies have had a significant impact on our business and operations:

- Development of strategic suppliers, and enhancement of direct operation with well-known domestic and international companies;

- Enhanced cooperation with qualified domestic manufacturers of equipment and suppliers of technology and services; and

Table of Contents

Increased focus on exploration and exploitation, and increased introductions of products and techniques through outsourcing with professional private enterprises in the remaining sectors of the industry chain, especially the development and production sectors.

These polices aim to establish long-term and stable supply channels and obtain better prices and higher quality services. They also help to speed up the nationalization of major equipment and critical materials and implementation of new products and services.

Accordingly, our businesses were affected in the following ways:

Previously, approximately one-third of our revenue came from our trading business with Sinopec by acting as an agent. This business was primarily conducted by our contractually controlled affiliate, ENI. We received orders mainly by tendering. Then we would need to use our own funds to purchase specified equipment and we get paid after the contract period (usually 1 year). With a previously high threshold for access in this market, we could make considerable profits. However, this aspect of our business has suffered as a result of the large oil companies policy adjustments. Especially for Sinopec, for the year 2010, its strategic procurement rate rose rapidly to 60%, and this ratio is expected to be over 80% by then end of China s 12th five year plan period. We do not manufacture such equipment ourselves and cannot meet the standards for being a strategic supplier to the large oil companies. As a result of such adjustments, our trading business, operated by ENI, has difficulty participating in larger projects with higher gross profits. We still have the ability to win smaller contracts with lower margin, however, occupying capital in such business is often inefficient. Thus, the contribution to revenue and net income from our trading business, operated by ENI, declined dramatically this quarter.

We now have the opportunity to focus more on our own branded equipment and automation system products and services, which we believe are technologically advanced and provide a price advantage.

We also have the capability of independent project construction. With fast improvement of our integrated design capabilities and rich experience of project construction, our management believes our advantage will be fully reflected and can benefit the company shortly in conjunction with proceeds from the capital market to undertake new engineering contracts.

In an effort to remediate the adverse effects of these market changes, our management is also actively adjusting our operating structure to strip non-essential businesses and keep our core business healthy. We are also accelerating extensive application of our own developed technologies and products and expanding our sales network to offset the declines to our trading business.

Factors Affecting Our Business

Business Outlook

The oilfield engineering and technical service industry is generally divided into five sections: (1) exploration, (2) drilling and completion, (3) testing and logging, (4) production, and (5) oilfield construction. Thus far our businesses have only been involved in production. Our management believes it s time to expand our core business, move into new markets, and develop new businesses. There are great opportunities both in new markets and our existing markets. We believe that many existing wells and oilfields need to improve or renew their equipment and service to maintain production and our techniques and services will be needed as new oil and gas fields are developed. In the next three years, we will focus on:

Measuring Equipment and Service. Our priority is the development of our well, pipeline and oilfield SCADA (Supervisory Control And Data Acquisition) engineering project contracting service, oilfield video surveillance and control system, and reforming technical support service. According to conservative estimates, the potential market for our wireless indicator and remote monitoring system (SCADA) is approximately RMB 5 billion.

Table of Contents

Gathering and Transferring Equipment. (1) Furnace. We estimate demands for our furnace at about 2,000 units per year, of which, 500 are expected to come from new wells and 1,500 are expected to come from reconstruction of old wells. The potential market is estimated at RMB 800 million (approximately $122 million) based on an average price of RMB 400,000 (approximately $60,882) per furnace. (2) Oil/water separator. We estimate demand at about 800 units per year, of which, 300 are expected to come from new wells and 500 are expected to come from reconstruction of old wells. The potential market is about RMB 400 million (approximately $61 million) based on an average price of RMB 500,000 (approximately $76,102); (3) Burner. We estimate demand at about 5,000 units per year, of which, 1,000 are expected to come from new wells and 4,000 are expected to come from reconstruction of old wells. The potential market is about RMB 300 million (approximately $46 million) based on an average price of RMB 60,000 (approximately $9,132).

New business. Along with the opening of the oilfield service market to private companies, we plan to establish our own service team equipped with work-over rigs (specialized equipment used during the operation of well repairing) and coiled tubing machines. We expect this service team to begin operating in the first half of the 2012 fiscal year. Only a few companies can provide this business in China at present.

Growth Strategy

As a small local company, it is our basic strategy to focus on developing our onshore oilfield business, i.e. the upstream of the industry. Due to the remote location and difficult environment of China s oil and gas fields, foreign competitors rarely enter those fields.

Large domestic oil companies prefer to focus on their exploration and development businesses to earn high margins and keep their competitive advantage. With regard to private oilfield service companies, 90% specialize in the manufacture of drilling and production equipment. Thus, the market for technical support and project service is still in its early stage. Our management insists on providing high quality products and service in the oilfield where we have a geographical advantage. This allows us to avoid conflicts of interest with bigger suppliers of drilling equipment and keep our leading position within the market segment. Our mission is to increase the automation and safety levels of industrial petroleum production in China, and improve the under-developed working process and management mode by using advanced technologies. At the same time, we are always looking to improve our business and to increase our earning capability.

Industry and Recent Developments

Oilfield drilling and production equipment and engineering technique services are applied in the process of oil and gas extraction, thus the exploration and exploitation activities of petroleum companies directly influences demand for oilfield technique service and corresponding equipment. At present, China is short of oil and gas. The discrepancy between production and demand is growing, sustaining high oil prices to a certain extent. This discrepancy significantly improves the business environment for petroleum equipment and service companies and is leading to rapid expansion of the market as oil companies increase capital expenditures on development.

With rapid growth of big petroleum companies overseas business, our management has expressed confidence with respect to the potential of our products and services in the international market based on the following factors:

- After experiencing 2009 lows, international oil and gas exploration expenditures surged. Increases in oil prices have continued for the last six months, and expenditures, which usually lag at around six months to one year, are expected to increase significantly throughout 2011 and 2012.

- The three big Chinese petroleum companies made large-scale overseas acquisitions of oil and gas fields since the global economic crisis, and are expected to enter into a three to five year period of further exploitation and development. Companies such as ours, which have established good relationships with the big three Chinese petroleum companies should be presented with significant opportunities.

- We believe we have a technique and cost advantage and are capable of growing at a faster rate by implementing more active sales strategies.

Table of Contents

Factors Affecting Our Results of Operations Generally

Our operating results in any period are subject to general conditions typically affecting the Chinese oilfield service industry including:

- the amount of spending by our customers, primarily those in the oil and gas industry;
- growing demand from large corporations for improved management and software designed to achieve such corporate performance;
- the procurement processes of our customers, especially those in the oil and gas industry;
- competition and related pricing pressure from other oilfield service solution providers, especially those targeting the Chinese oil and gas industry;
- the ongoing development of the oilfield service market in China; and
- inflation and other factors.

Unfavorable changes in any of these general conditions could negatively affect the number and size of the projects we undertake, the number of products we sell, the amount of services we provide, the price of our products and services and otherwise affect our results of operations.

Our operating results in any period are more directly affected by company-specific factors including:

- our revenue growth;
- the proportion of our business dedicated to large companies;
- our ability to successfully develop, introduce and market new solutions and services;
- our ability to increase our revenues to businesses, both old customers and new in the Chinese oil and gas industry;
- our ability to effectively manage our operating costs and expenses; and
- our ability to effectively implement any targeted acquisitions and/or strategic alliances so as to provide efficient access to markets and industries in the Chinese oil and gas industry.

Critical Accounting Policies and Estimates

Estimates and Assumptions. We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP), which requires us to make judgments, estimates and assumptions. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. An accounting policy is considered critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time such estimate is made, and if different accounting estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. We believe that the following policies involve a higher degree of judgment and complexity in their application and require us to make significant accounting estimates. The following descriptions of critical accounting policies, judgments and estimates should be read in conjunction with our consolidated financial statements and other disclosures included in this quarterly report. Significant accounting estimates reflected in our Company s consolidated financial statements include revenue recognition, allowance for doubtful accounts, and useful lives of property and equipment.

Revenue Recognition. We recognize revenue when the following four criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been provided, (3) the sales price is fixed or determinable, and (4) collectability is reasonably assured. Delivery does not occur until products have been shipped or services have been provided to the client and the client has signed a completion and acceptance report, risk of loss has transferred to the client, client acceptance provisions have lapsed, or the Company has objective evidence that the criteria specified in client acceptance provisions have been satisfied. The sales price is not considered to be fixed or determinable until all contingencies related to the sale have been resolved.

Table of Contents

Hardware:

Revenue from hardware sales is generally recognized when the product is shipped to the customer and when there are no unfulfilled company obligations that affect the customer s final acceptance of the arrangement.

Software:

The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with ASC 985-605, Software Revenue Recognition, and related interpretations. Revenue from software is recognized according to project contracts. Contract costs are accumulated during the periods of installation and testing or commissioning. Usually this is short term. Revenue is not recognized until completion of the contracts and receipt of acceptance statements.

Services:

The Company provides services to improve software functions and system requirements on separated fixed-price contracts. Revenue is recognized on the completed contract method when acceptance is determined by a completion report signed by the customer.

Deferred income represents unearned amounts billed to customers related to sales contracts.

Cost of Revenues. When the criteria for revenue recognition have been met, costs incurred are recognized as cost of revenue. Cost of revenues includes wages, materials, handling charges, the cost of purchased equipment and pipes, and other expenses associated with manufactured products and services provided to customers. We expect cost of revenues to grow as our revenues grow. It is possible that we could incur development costs with little revenue recognition, but based upon our past history, we expect our revenues to grow.

Fair Values of Financial Instruments. The carrying amounts reported in the consolidated balance sheets for trade accounts receivable, other receivables, advances to suppliers, trade accounts payable, accrued liabilities, advances from customers and notes payable approximate fair value because of the immediate or short-term maturity of these financial instruments.

Allowance for Doubtful Accounts. Trade receivables and other receivable accounts are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less a provision made for impairment of these receivables. Provisions are applied to trade and other receivables where events or changes in circumstances indicate that the balance may not be collectible. The identification of doubtful debts requires the use of judgment and estimates of management. Our management must make estimates of the collectability of our accounts receivable. Management specifically analyzes accounts receivable, historical bad debts, customer creditworthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our allowance for trade accounts receivable was ¥1,089,331 and ¥2,196,723 ($334,351) on June 30, 2010 and March 31, 2011 respectively. Allowance for other receivables was ¥154,057 and ¥6,984,535 ($1,063,079) on June 30, 2010 and March 31, 2011 respectively

Property and Equipment. We record property and equipment at cost. We depreciate property and equipment on a straight-line basis over their estimated useful lives using the following annual rates:

Items	Useful life
Motor Vehicles	10 years
Office Equipment	2-5 years
Leasehold Improvements	5 years

We expense maintenance and repair expenditures as they do not improve or extend an asset s productive life. These estimates are reasonably likely to change in the future since they are based upon matters that are highly uncertain such as general economic conditions, potential changes in technology and estimated cash flows from the use of these assets.

Table of Contents

Software Development Costs. We charge all of our development costs to research and development until we have established technological feasibility. We acknowledge technological feasibility of our software when a detailed program design has been completed, or upon the completion of a working model. Upon reaching technological feasibility, we capitalize additional software costs until the software is available for general release to customers. Although we have not established a budget or time table for software development, we anticipate the need to continue the development of our software products in the future and the cost could be significant. We believe that, as in the past, the costs of development will result in new products that will increase revenue and therefore justify costs. There is, however, a reasonable possibility that we may be unable to realize the carrying value of our software, and the amount not so realized may adversely affect our financial position, results of operation or liquidity in the future.

Valuation of Long-Lived Assets. We review the carrying values of our long-lived assets for impairment whenever events or changes in circumstances indicate that they may not be recoverable. When such an event occurs, we project undiscounted cash flows to be generated from the use of the asset and its eventual disposition over the remaining life of the asset. If projections indicate that the carrying value of the long-lived asset will not be recovered, we reduce the carrying value of the long-lived asset by the estimated excess of the carrying value over the projected discounted cash flows. In the past, we have not had to make significant adjustments to the carrying values of our long-lived assets, and we do not anticipate a need to do so in the future. However, circumstances could cause us to have to reduce the value of our capitalized software more rapidly than we have in the past if our revenues were to significantly decline. Estimated cash flows from the use of the long-lived assets are highly uncertain and therefore the estimation of the need to impair these assets is reasonably likely to change in the future. Should the economy or acceptance of our software change in the future, it is likely that our estimate of the future cash flows from the use of these assets will change by a material amount.

Table of Contents

Results of Operations

The following consolidated results of operations include the results of operations of the Company, all the contractual subsidiaries, which are BHD, Nanjing Recon and ENI of the Company. The results of operations are primarily those of the contractual subsidiaries.

Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010

Our historical reporting results are not necessarily indicative of the results to be expected for any future period.

Revenue

	For the Three Months Ended March 31,			
	2011	**2010**	**Decrease**	**Percentage Change**
Hardware	¥ 11,108,566	¥ 24,578,963	¥ (13,470,397)	(54.80%)
Service	¥	¥ 1,709,402	¥ (1,709,402)	(100%)
Total Revenue	¥ 11,108,566	¥ 26,288,365	¥ (15,179,799)	(57.74%)

Revenues. Our total revenues were ¥11,108,566 ($1,690,776), a decrease of 57.74% or ¥15,179,799 from ¥26,288,365 for the three months ended March 31, 2010. During this three months period, sales of transportation equipment increased by 20.42%, while our automation business decreased by 61.82% and our accessory sales business decreased over 80.30%. The decrease in our revenues for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 was due to the following operating challenges: (1) as described above, some of our large clients, especially Sinopec, adjusted their procurement policies, to increase direct purchases from strategic manufacturers rather than purchase from agency companies. Additionally, our former Chief Marketing Officer, Mr. Li Hongqi, resigned effective January 31, 2011. When Mr. Li resigned, we lost our established relationship with Sinopec and other companies. Without such relationships, it was very difficult for us to compete with the large strategic suppliers adopted by the large oil companies under their new procurement policies, thus decreasing our revenues as an agent for hardware sales; and (2) our equipment and service terminals can only be assembled and operated after completion of field infrastructure. Currently, our major on-going projects are all located in Ji dong oilfield and Weston Sichuan gas field, which are both newly developed oil and gas fields, with relatively long construction periods. Since some of our clients have not finished their oilfield construction, which in turn caused delays in our projects, we could not provide equipment to our clients and recognize the corresponding revenue as scheduled, this is also the reason for our increase of inventories for this period.

As discussed above, the changes to our clients procurement policies may have long-term adverse effects on our operation and our management believes we need to adjust our business structure to place a greater emphasis on our high efficiency equipment and service business. Short-term priorities for our management are:

- Reevaluate the agency trading department operated by ENI and find the most appropriate way to proceed with this business. Our management intends to evaluate the remaining relationships with clients and suppliers in the agency trading business to determine the best course of action for the Company to minimize the impact of the declining agency trading business; and

- Expansion of our sales network and establishment of relationships with new clients to receive larger overall packages.

Our management intends to pursue these goals in an effort to maximize shareholder value, overcome recent declines, and progress with the Company s long-term goals and strategies.

Table of Contents

Cost and Margin

	For the Three Months Ended March 31,			
	2011	2010	Increase (Decrease)	Percentage Change
Total Revenue	¥ 11,108,566	¥ 26,288,365	¥ (15,179,799)	(57.74%)
Cost of Revenue	¥ 9,123,575	¥ 14,538,530	¥ (5,414,955)	(37.25%)
Gross Margin	¥ 1,984,991	¥ 11,749,835	¥ (9,764,844)	(83.11%)
Margin %	17.87%	44.70%	(26.83%)	

Cost of Revenues. Our cost of revenues includes raw materials and costs related to design, implementation, delivery and maintenance of products and services. We are a light-asset company, and all materials and components we need can be purchased or manufactured under contract. Usually the price of electronic components doesn t fluctuate violently due to competitive forces, and it will not affect our cost significantly. Specialized equipment and incentive chemical products can be influenced directly if the price for metal and oil changes. Additionally, the price for some imported accessories appointed by our clients can also impact our cost.

Our cost of revenues decreased from ¥14,538,530 in the three months ended March 31, 2010 to ¥9,123,575 ($1,388,651) for the same period of 2011, a decrease of ¥5,414,955 or 37.25%. As a percentage of revenues, our cost of revenues increased from 55.30% in the three months ended March 31, 2010 to 82.13% in the three months ended March 31, 2011. During this period, the decrease in cost of revenues was mainly caused by the decrease in our agency business and project delays. As our agency business is high margin, when that business declined, our cost of revenue as a percentage of revenue increased.

Gross Profit. For the three months ended March 31, 2011, our gross profit decreased to ¥1,984,991 ($302,125) from ¥11,749,835 for the same period in 2010, a decrease of ¥9,764,844, or approximately 83.11%. For the three months ended March 31, 2011, our gross profit as a percentage of revenue decreased to 17.87%, from 44.70% for the same period in 2010. As a result of a decrease in our revenue and increased cost as a percentage of our revenue, our gross profit decreased and gross margin dropped. Our management believes that a higher margin level is very important to secure our business. Additionally, as more and more domestic peer companies go public in Chinese capital markets, the oilfield service industry is becoming more and more competitive. To maintain our position and profitability in our segmented market, our management plans to focus its efforts on research and development of our products and expansion of our service business. We also plan to actively finance our development.

Expenses

Operating Expenses

	For the Three Months Ended March 31,			
	2011	2010	Increase (Decrease)	Percentage Change
Selling and Distribution Expenses	¥ 1,449,192	¥ 1,534,090	¥ (84,898)	(5.53%)
Percentage of Revenue	13.05%	5.84%	7.21%	
General and Administrative expenses	¥ 8,183,056	¥ 3,337,591	¥ 4,845,465	145.18%
Percentage of Revenue	73.66%	12.70%	60.96%	
Operating Expenses	¥ 9,632,248	¥ 4,871,681	¥ 4,760,567	97.72%

Selling and Distribution Expenses. Selling and distribution expenses consist primarily of salaries and related expenditures of our sales and marketing department, sales commissions, costs of our marketing programs, including

Table of Contents

public relations, advertising and trade shows; and an allocation of our facilities and depreciation expenses. Selling expenses decreased by 5.53%, from ¥1,534,090 for the three months ended March 31, 2010 to ¥1,449,192 ($220,574) for the same period of 2011. Selling and distribution expenses were 5.84% of total revenues in the three months ended March 31, 2010 and 13.05% of total revenues in the same period in 2011. The overall decrease is mainly attributable to decreased expenses for our trading department, while selling and distribution expenses increased as a percentage of revenues due to more active sales activities in our two departments. Selling expenses for the automation department increased the most as the cost of developing business with new clients in a new area is high. Our management expects this will bring direct benefits within six months.

General and Administrative Expenses. General and administrative expenses consist primarily of costs from our human resources organization, facilities costs, provision of bad debt, depreciation expenses, professional advisor fees, audit fees and other expenses incurred in connection with general operations. General and administrative expenses increased 145.18%, or ¥4,845,465, from ¥3,337,591 in the three months ended March 31, 2010 to ¥8,183,056 ($1,245,499) for the same period of 2011. General and administrative expenses were 12.70% of total revenues in the three months ended March 31, 2010 and 73.66% of total revenues in the same period in 2011. This percentage increase was primarily attributable to the decline of our trading business, the change of operating structure and our management s decision to make some allowance for purchase advances related to certain projects. Specifically, we made advanced orders and purchases in anticipation of the continued flow of business through ENI. With the decline of ENI s business, we are now left with little option as to how to dispose of the advances purchases. As such, our management made very cautious estimates about the possible loss of these advanced payments and recognized it as expenses in this period.

Income (Loss) from Operations. Due to the decline of our agency trading business, the uncertainty associated with the recovery of advance payments we made, and our efforts to expand our sales channels, our revenue during the period decreased while our administrative expenses increased, causing our income from operations for the period to decrease by ¥211.18%, or ¥14,525,410, to loss of ¥7,647,257 ($ 1,163,948) for the three months ended March 31, 2011, compared to ¥6,878,153 for the same period of 2010.

Subsidy Income. We received grants of ¥20,000 and ¥341,025 ($51,906) from the local government for the three months ended March 31, 2010 and 2011, respectively. These grants were given by the government as return of income tax to support local companies to develop high technology and improve their products.

Income Tax Expense. Income taxes are provided based upon the liability method of accounting pursuant to ASC No. 740, Accounting for Income Taxes. Under this approach, deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reporting amounts. A valuation allowance is recorded against deferred tax assets if it is not likely that the asset will be realized. We have not been subject to any income taxes in the United States or the Cayman Islands. Enterprises doing business in PRC are generally subject to federal (state) enterprise income tax at a rate of 25%; however, Nanjing Recon and BHD were granted certifications of High Technology Enterprise and are taxed at a rate of 15% for taxable income generated. The applicable tax rate for each of our subsidiaries changed in the past few years because of their qualifications and different local policies. From calendar year 2010 and 2011, Nanjing Recon and BHD are taxed at a rate of 15% and ENI is still taxed at 25%. Our effective EIT burden will vary, depending on which of our domestic companies generate greater revenue.

Income tax expense for three months ended March 31, 2010 and 2011 was ¥2,082,801 and ¥174,898 ($26,620), respectively. This decrease was mainly due to a decrease in taxable operating income.

Net Income (Loss) Attributable to Ordinary Shareholders. As a result of the factors described above, net loss attributable to ordinary shareholders was ¥7,384,290 ($1,123,924) for the three months ended March 31, 2011, a decrease of 263.21%, or ¥11,908,641 over net income of ¥4,524,351 for the same period of 2010.

Table of Contents

ADJUSTED EBITDA

	For the Three Months Ended March 31,				
	2011 RMB (Unaudited)	2010 RMB (Unaudited)	Increase (Decrease)	Percentage Change	2011 U.S. Dollars (Unaudited)
Reconciliation of Adjusted EBITDA from Net Income (Loss):					
Net income (loss) from continuing operations	¥ (7,295,092)	¥ 5,172,178	¥ (12,467,270)	(241.04%)	$ (1,110,347)
Income tax expense	174,898	2,082,801	(1,907,903)	(91.60%)	26,620
Interest expense	99,543	32,841	66,702	203.11%	15,151
Stock compensation expense	268,180	442,013	(173,833)	(39.33%)	40,818
Depreciation, amortization and accretion	100,526	92,172	8,354	9.06%	15,301
Adjusted EBITDA	¥ (6,651,945)	¥ 7,822,005	¥ (14,473,950)	(185.04%)	$ (1,012,457)

Adjusted EBITDA. We define Adjusted EBITDA as income from continuing operations before income tax expense, interest expense, non-cash stock compensation expense, and depreciation, amortization and accretion expense. We think it is useful to an equity investor in evaluating our operating performance because: (1) it is widely used by investors in our industry to measure a company s operating performance without regard to items such as interest expense, depreciation and amortization, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which the assets were acquired; and (2) it helps investors more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating results.

Adjusted EBITDA decreased ¥14,473,950 or 185.04% to negative EBITDA of ¥6,651,945 for the three months ended March 31, 2011 compared to the same period in 2010. This was due to the decline of our agency trading department and the large expense allowance for purchase advance payment. These factors caused revenues during the period to decrease while our administrative expenses increased. Compared to the 263.21% decrease in net income attributable to ordinary shareholders, we believe EBITDA more accurately reflects our operations.

Table of Contents

Nine Months Ended March 31, 2011 Compared to Nine Months Ended March 31, 2010

Our historical reporting results are not necessarily indicative of the results to be expected for any future period.

Revenue

	For the Nine Months Ended March 31,			
	2011	2010	Increase (Decrease)	Percentage Change
Hardware	¥ 77,754,951	¥ 90,932,348	¥ (13,177,397)	(14.49%)
Service	¥ 2,111,111	¥ 7,675,214	¥ (5,564,103)	(72.49%)
Software	¥	¥ 226,496	¥ (226,496)	(100.00%)
Total Revenue	¥ 79,866,062	¥ 98,834,057	¥ (18,967,996)	(19.19%)

Revenues. Our total revenues for the nine months ended March 31, 2011 were ¥79,866,062 ($12,155,989), a decrease of 19.19% from ¥98,834,057 for the nine months ended March 31, 2010. During this nine months period, our automation business decreased approximately 17.99%, our accessory sales business decreased by 28.67% and sales of transportation equipment decreased by 6.78%. This was mainly caused by: (1) our shrinking accessory agency business; and (2) delays in some of our projects caused by our clients field construction, all as described in more detail in the three months discussion.

Cost and Margin

	For the Nine Months Ended March 31,			
	2011	2010	Increase (Decrease)	Percentage Change
Total Revenue	¥ 79,866,062	¥ 98,834,057	¥ (18,967,995)	(19.19%)
Cost of revenue	¥ 50,332,089	¥ 56,007,688	¥ (5,675,599)	(10.13%)
Gross margin	¥ 29,533,973	¥ 42,826,369	¥ (13,292,396)	(31.04%)
margin %	36.98%	43.33%	(6.35%)	

Cost of Revenues. Our cost of revenues decreased 10.13% from ¥56,007,688 in the nine months ended March 31, 2010 to ¥50,332,089 ($7,660,780) for the same period of 2011. As a percentage of revenues, our cost of revenues increased from 56.67% in the nine months ended March 31, 2010 to 63.02% in the same period of 2011. This increase was a result of (1) the decline of our agency trading business which resulted in the loss of our high margin orders, leaving us with only smaller orders with smaller margins; and (2) unfinished service projects, that have higher margins.

Gross Profit. For the nine months ended March 31, 2011, our gross profit decreased to ¥29,533,973 ($4,495,209) from ¥42,826,369 for the same period in 2010, a decrease of ¥13,292,396, or approximately 31.04%. For the nine months ended March 31, 2011, our gross profit as a percentage of revenue decreased to 36.98%, from 43.33% for the same period in 2010. Our management believes it is necessary to adjust our business structure to maintain a higher margin ratio. We plan to accomplish this by focusing more on our automation business and self-developed products and services, while shifting our focus away from agency sales, which provide now a lower margin.

The capital and technology intensive nature of our industry, abundant capital strength and spending of oil companies and a higher threshold for access make it possible for suppliers to earn high yields. As to sales of

Table of Contents

equipment and accessories, our gross margin remains at approximately 29% (a basic level), margin of automation products is approximately 29% and that of oilfield service and project engineering service can be higher than 44%. It s our strategy to improve our operating results by participating in more projects and increasing the services we provide.

Expenses

Operating expenses

	For the Nine Months Ended March 31,			
	2011	2010	Increase (Decrease)	Percentage Change
Selling and Distribution Expenses	¥ 6,545,509	¥ 7,557,188	¥ (1,011,679)	(13.39%)
Percentage of Revenue	8.20%	7.65%	0.55%	
General and Administrative Expenses	¥ 19,908,120	¥ 9,803,491	¥ 10,104,629	103.07%
Percentage of Revenue	24.93%	9.92%	15.01%	
Operating Expenses	¥ 26,453,629	¥ 17,360,679	¥ 9,092,950	52.38%

Selling and Distribution Expenses. Selling expenses decreased by 13.39%, from ¥7,557,188 for nine months ended March 31, 2010 to ¥6,545,509 ($996,257) for the same period of 2011. This decrease is mainly attributed to the shrinking of our trading department and its selling activities.

General and Administrative Expenses. General and administrative expenses increased 103.07%, or ¥10,104,629, from ¥9,803,491 in nine months ended March 31, 2010 to ¥19,908,120 ($3,030,109) for the same period of 2011. General and administrative expenses were 9.92% of total revenues for the nine months ended March 31, 2010 and 24.93% of total revenues in the same period in 2011. This percentage increase was primarily attributable to (1) the increased allowance of advance payment related to the trading business in the event we cannot sell related goods as we have planned ; (2) increased expenses related to our planned secondary offering, which was withdrawn due to unfavorable market conditions; and

Income from Operations. Income from operations was ¥3,080,344 ($468,843) for the nine months ended March 31, 2011, compared to ¥25,465,690 for the same period of 2010. As a result of lower revenue and higher administrative expenses, income from operations decreased during this period.

Subsidy Income. We received grants of ¥1,178,034 and ¥792,545 ($120,629) from the local government for the nine months ended March 31, 2010 and 2011, respectively. These grants were given by the government as return of income tax to support local companies to develop advanced technology and improve their products.

Income Tax Expense. Income tax expense for nine months ended March 31, 2010 and 2011 was ¥7,189,566 and ¥1,561,897 ($237,728), respectively. This decrease was mainly due to a decrease in taxable operating income.

Net Income Attributable to Ordinary Shareholders. As a result of the factors described above, net income attributable to ordinary shareholders was ¥1,284,907 ($195,568) for the nine months ended March 31, 2011, a decrease of 92.66% over ¥16,218,016 for the same period of 2010.

Table of Contents

ADJUSTED EBITDA

	For the Nine Months Ended March 31,				
	2011 RMB (Unaudited)	2010 RMB (Unaudited)	Increase (Decrease)	Percentage Change	2011 U.S. Dollars (Unaudited)
Reconciliation of Adjusted EBITDA from Net Income:					
Income from continuing operations	¥ 2,180,232	¥ 19,821,690	¥ (17,641,458)	(89.00%)	$ 331,842
Income tax expense	1,561,897	7,189,566	(5,627,669)	(78.28%)	237,728
Interest expense	426,339	110,075	316,264	287.32%	64,891
Stock compensation expense	1,138,264	1,178,701	(40,437)	(3.43%)	173,249
Depreciation, amortization and accretion	303,804	263,036	40,768	15.50%	46,240
Adjusted EBITDA	¥ 5,610,536	¥ 28,563,068	¥ (22,952,532)	(80.36%)	$ 853,950

Adjusted EBITDA. We define Adjusted EBITDA as income from continuing operations before income tax expense, interest expense, non-cash stock compensation expense, and depreciation, amortization and accretion expense. We think it is useful to an equity investor in evaluating our operating performance because: (1) it is widely used by investors in our industry to measure a company s operating performance without regard to items such as interest expense, depreciation and amortization, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which the assets were acquired; and (2) it helps investors more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating results.

Adjusted EBITDA decreased ¥22,952,532 or 80.36% to ¥5,610,536 ($853,950) for the nine months ended March 31, 2011 compared to the same period in 2010. This was due to the construction delays experienced by some of our customers, and of the decline of our agency trading business and related issues caused by payment advance for goods. These factors caused revenues during the period to decrease while our administrative expenses increased. Compared to the 80.36% decrease in net income attributable to ordinary shareholders, we believe EBITDA more accurately reflects our operations.

Liquidity and Capital Resources.

General

Cash and Cash Equivalents. Cash and cash equivalents are comprised of cash on hand, demand deposits and highly liquid short-term debt investments with stated maturities of no more than six months. As of March 31, 2011, we had cash and cash equivalents in the amount of ¥16,620,761 ($2,529,758).

Indebtedness. As of March 31, 2011, except for ¥7,188,425 ($1,094,112) of short-term borrowings and a ¥5,000,000 ($761,023) commercial loan from a local bank, we did not have any finance leases or purchase commitments, guarantees or other material contingent liabilities.

Holding Company Structure. We are a holding company with no operations of our own. All of our operations are conducted through the Domestic Companies. As a result, our ability to pay dividends and to finance any debt that we may incur is dependent upon the receipt of dividends and other distributions from the Domestic Companies. In addition, Chinese legal restrictions permit payment of dividends to us by our Domestic Companies only out of its accumulated net profit, if any, determined in accordance with Chinese accounting standards and regulations. Under Chinese law, the Domestic Companies are required to set aside a portion (at least 10%) of their after-tax net income (after discharging all cumulated loss), if any, each year for compulsory statutory reserve until the amount of the reserve reaches 50% of the Domestic Companies registered capital. These funds may be distributed to shareholders at the time of wind up. When we were incorporated in the Cayman Islands in August 2007, 5,000,000 ordinary shares were authorized, and 50,000 ordinary shares were issued to Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi, at a par value of $0.01 each. On December 10, 2007, our company sold 2,632 ordinary shares to an investor at an aggregate consideration of $200,000. On June 8, 2009, in connection with our initial public offering, the Board of Directors approved a 42.7840667-to-1 split of ordinary shares and redeemable ordinary shares to shareholders of record as of such date. After giving effect to the share split of our ordinary shares and the completion of our initial public offering, we had 3,951,811 ordinary shares outstanding.

Off-Balance Sheet Arrangements. We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of any third parties. In addition, we have not entered into any derivative contracts that are indexed to our own shares and classified as shareholders equity, or that are not reflected in our financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. Moreover, we do not have any variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

Capital Resources. To date we have financed our operations primarily through cash flows from operations. As of March 31, 2011 we had total assets of ¥176,635,836 ($26,884,801), which includes cash amounting to ¥16,620,761 ($2,529,758), and net accounts receivable amounting to ¥83,080,495 ($12,645,241). Working capital amounted to ¥121,018,093 ($18,419,521) and shareholders equity amounted to ¥122,344,619 ($18,621,424).

Cash from Operating Activities. Net cash provided by operating activities was ¥4,787,066 ($728,614) for the nine months ended March 31, 2011. This was an increase of ¥46,293,943 compared to cash of ¥41,506,877 used in operating activities for the nine months ended March 31, 2010. The change is mainly attributed to the favorable collection of accounts receivable and less payment for purchase of goods.

Cash from Investing Activities. Net cash used in investing activities was ¥147,449 ($22,442) for the nine months ended March 31, 2011, relatively stable compared to the same period in 2010.

Cash from Financing Activities. Cash flows used in financing activities amounted to ¥179,913 ($27,384) for the nine months ended March 31, 2011 and cash flows provided by financing activities amounted to ¥61,471,426 for the nine months ended March 31, 2010. The decrease was because we received our IPO funds in the same period of 2010. During the nine months ended March 31, 2011, we borrowed ¥5,000,000 ($761,023) from a domestic commercial bank to supplement working capital. While at the same time, we paid back some due-on-demand loans to Wu Jin, the manager and a minority shareholder of ENI, and the wife of our former CMO, Hongqi Lo. Specifically, for the nine months ended March 31, 2011, we paid back ¥4,300,000 ($654,480) to Wu Jin.

Working Capital. Total current assets as of March 31, 2011 amounted to ¥175,309,310 ($26,682,898), an increase of ¥144,905 ($22,055) compared to ¥175,164,405 at June 30, 2010. This was relatively stable across periods.

Current liabilities amounted to ¥54,291,217 ($8,263,377) at March 31, 2011, in comparison to ¥57,563,362 at June 30, 2010. This decrease has been attributed to the decrease in trade accounts payable and deferred income caused by less business and contracts.

The current ratio increased from 3.04 at June 30, 2010 to 3.23 in March 31, 2011. The change in our current ratio was primarily due to the decrease of current liabilities.

Recently Enacted Accounting Standards

In the quarter ended March 31, 2011, The Financial Accounting Standards Board (FASB) has issued ASU No. 2011-01 through ASU 2011-3, which is not expected to have a material impact on the consolidated financial statements upon adoption.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Not applicable.

Item 4/4T. Controls and Procedures

Disclosure Controls and Procedures

As of March 31, 2011, our company carried out an evaluation, under the supervision of and with the participation of management, including our company s chief executive officer and chief financial officer, of the effectiveness of the design and operation of our company s disclosure controls and procedures. Based on the foregoing, the chief executive officer and chief financial officer concluded that our company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective.

Changes in Internal Control over Financial Reporting

There were no changes in our company s internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) during the quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our company s internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A Risk Factors

Not applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None

(b) The section entitled Use of Proceeds from our registration statement filed on August 12, 2008, as amended (the Registration Statement) is incorporated herein by reference. The effective date of the Registration Statement is July 22, 2009, and the Commission file number assigned to the Registration Statement is 333-152964. The Registration Statement registers the offering of up to 1,700,000 ordinary shares (subject to amendment in accordance with the Securities Act of 1933 and the rules and regulations promulgated thereunder) (the Offering). As of March 31, 2011, the Company has spent proceeds from the Offering in accordance with the following chart:

Description of Use	**Proposed Expenditure Amount**	**Actual Expenditures through March 31, 2011**
Product Research and development	$ 1,273,024	$ 0
Acquisition and business development in oil-field industry in China and globally	4,073,675	5,000,000
Sarbanes-Oxley compliance	424,341	0
Fixed asset purchases	442,341	0
Employee training	169,736	6,639
General working capital	2,121,706	1,350,261
Total	**$ 8,486,824**	**$ 6,356,900**

(c) None

Item 3. Defaults upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

The following exhibits are filed herewith:

Exhibit Number	Document
3.1	Amended and Restated Articles of Association of the Registrant (1)
3.2	Amended and Restated Memorandum of Association of the Registrant (1)
4.1	Specimen Share Certificate (1)
10.1	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.2	Translation of Power of Attorney for rights of Chen Guangqiang in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.3	Translation of Power of Attorney for rights of Yin Shenping in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.4	Translation of Power of Attorney for rights of Li Hongqi in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.5	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.6	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.7	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.8	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.9	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.10	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.11	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Jining ENI Energy Technology Co., Ltd. (1)
10.12	Translation of Power of Attorney for rights of Chen Guangqiang in Jining ENI Energy Technology Co., Ltd. (1)
10.13	Translation of Power of Attorney for rights of Yin Shenping in Jining ENI Energy Technology Co., Ltd. (1)
10.14	Translation of Power of Attorney for rights of Li Hongqi in Jining ENI Energy Technology Co., Ltd. (1)
10.15	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Jining ENI Energy Technology Co., Ltd. (1)
10.16	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Jining ENI Energy Technology Co., Ltd. (1)
10.17	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Jining ENI Energy Technology Co., Ltd. (1)
10.18	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Jining ENI Energy Technology Co., Ltd. (1)

10.19	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Jining ENI Energy Technology Co., Ltd. (1)
10.20	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Jining ENI Energy Technology Co., Ltd. (1)
10.21	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Nanjing Recon Technology Co., Ltd. (1)
10.22	Translation of Power of Attorney for rights of Chen Guangqiang in Nanjing Recon Technology Co., Ltd. (1)
10.23	Translation of Power of Attorney for rights of Yin Shenping in Nanjing Recon Technology Co., Ltd. (1)
10.24	Translation of Power of Attorney for rights of Li Hongqi in Nanjing Recon Technology Co., Ltd. (1)
10.25	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Nanjing Recon Technology Co., Ltd. (1)
10.26	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Nanjing Recon Technology Co., Ltd. (1)
10.27	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Nanjing Recon Technology Co., Ltd. (1)
10.28	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Nanjing Recon Technology Co., Ltd. (1)
10.29	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Nanjing Recon Technology Co., Ltd. (1)
10.30	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Nanjing Recon Technology Co., Ltd. (1)
10.33	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Yin Shenping (1)
10.34	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Chen Guangqiang (1)
10.35	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Li Hongqi (1)
10.36	Summary Translation of Technical Service Contract by and between Natural Gas Development Company of Qinghai Oilfield and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.37	Summary Translation of Sales Contract, by and between the West Site Department of Bazhou, Zhongyuan Petroleum Exploration Bureau Project Construction Corporation and Jining ENI Energy Technology Co., Ltd. (1)
10.38	Ordinary Shares Subscription Agreement dated December 31, 2007 between the Registrant and Bloomsway Development Ltd (1)
10.39	Translation of Contract for the Sale of Industrial and Mineral Products between Nanjing Recon Technology Co., Ltd. and PetroChina Qinghai Oilfield Co., Ltd. (1)
10.40	Translation of Contract of Material Reserves and Sales between Beijing BHD Petroleum Technology Co., Ltd. and PetroChina Qinghai Oilfield Co., Ltd. (1)
10.41	Translation of Contract of Material Reserves and Sales between Beijing BHD Petroleum Technology Co., Ltd. and PetroChina Qinghai Oilfield Co., Ltd. (1)
10.42	Translation of Contract for Purchasing Vacuum-Heating-Furnace between Beijing BHD Petroleum Technology Co., Ltd. and PetroChina Huabei Oilfield Co., Ltd. (1)

Table of Contents

10.43	Translation of Contract of the Sale of Goods between Beijing BHD Petroleum Technology Co., Ltd. and PetroChina Huabei Oilfield Co., Ltd. (1)
10.44	Summary Translation of Chuan East to Chuan West Transferring Gas Pipe Project Product Collective Contract between Jining ENI Energy Technology Co., Ltd. and Southwest Oil Gas Company of Sinopec. (1)
10.45	Summary Translation of Industrial Product Purchasing Agreement between Jining ENI Energy Technology Co., Ltd. and Southwest Oil Gas Company of Sinopec. (1)
10.46	Summary Translation of Purchase Agreement between Jining ENI Energy Technology Co., Ltd. and Southwest Oil Gas Company of Sinopec. (1)
10.47	Summary Translation of Chuan East to Chuan West Transferring Gas Pipe Project Product Collective Contract between Jining ENI Energy Technology Co., Ltd. and Southwest Oil Gas Company of Sinopec. (1)
10.48	Operating Agreement among Recon Technology (Jining) Co. Ltd., Nanjing Recon Technology Co., Ltd. and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
10.49	Operating Agreement among Recon Technology (Jining) Co. Ltd., Jining ENI Energy Technology Co., Ltd., and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
10.50	Operating Agreement among Recon Technology (Jining) Co. Ltd., Beijing BHD and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
21.1	Subsidiaries of the Registrant (1)
99.1	Stock Option Plan (1)
99.2	Code of Business Conduct and Ethics (1)
31.1	Certifications pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
31.2	Certifications pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
32.1	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)
32.1	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)

(1) Incorporated by reference to the Company s Registration Statement on Form S-1, Registration No. 333-152964.
(2) Filed herewith.

Table of Contents

SIGNATURES

In accordance with the requirements of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

RECON TECHNOLOGY, LTD

May 16, 2011

By: /s/ Liu Jia
Liu Jia
Chief Financial Officer
(Principal Financial and Accounting Officer)

RECON TECHNOLOGY, LTD

INDEX TO FINANCIAL STATEMENTS

Table of Contents

RECON TECHNOLOGY, LTD

CONSOLIDATED BALANCE SHEETS

	June 30, 2010 **RMB**	March 31, 2011 **RMB** **(Unaudited)**	March 31, 2011 **U.S. Dollars** **(Unaudited)**
ASSETS			
Current assets			
Cash and cash equivalents	¥ 12,142,957	¥ 16,620,761	$ 2,529,758
Trade accounts receivable, net	89,425,990	83,080,495	12,645,241
Other receivables, net	12,850,547	17,794,691	2,708,435
Purchase advances	46,551,402	16,878,362	2,568,966
Prepaid expenses	766,638	1,228,887	187,042
Inventories	13,150,911	37,644,403	5,729,654
Deferred tax assets	275,960	2,061,711	313,802
Total current assets	**175,164,405**	**175,309,310**	**26,682,898**
Property and equipment, net	1,482,881	1,326,526	201,903
Total Assets	**¥ 176,647,286**	**¥ 176,635,836**	**$ 26,884,801**
LIABILITIES AND EQUITY			
Current liabilities			
Trade accounts payable	¥ 16,536,796	¥ 14,859,767	$ 2,261,727
Other payables	3,096,309	2,589,053	394,066
Deferred income	4,267,711	2,853,075	434,251
Advances from customers	439,761		
Accrued payroll and employees welfare	360,540	117,562	17,893
Accrued expenses	290,803	313,747	47,754
Taxes payable	20,203,104	21,369,588	3,252,551
Short-term bank loan		5,000,000	761,023
Short-term borrowings	5,024,881	3,913,820	595,702
Short-term borrowings-related parties	7,343,457	3,274,605	498,410
Total current liabilities	**57,563,362**	**54,291,217**	**8,263,377**
Total Liabilities	**57,563,362**	**54,291,217**	**8,263,377**
Commitments and Contingencies			
Equity			
Ordinary shares ($ 0.0185 U.S. dollar par value, 25,000,000 shares authorized; 3,951,811 and respectively shares issued and outstanding of June 30, 2010 and March 31, 2011, respectively)	529,979	529,979	80,665
Additional paid-in capital	69,257,098	70,394,755	10,714,412
Appropriated retained earnings	3,755,503	4,396,641	669,189
Unappropriated retained earnings	36,034,500	36,678,269	5,582,604
Accumulated other comprehensive loss	(76,997)	(128,472)	(19,554)
Total controlling shareholders equity	**109,500,083**	**111,871,172**	**17,027,316**
Non-controlling interest, net of tax	**9,583,841**	**10,473,447**	**1,594,108**

Total equity	**119,083,924**	**122,344,619**	**18,621,424**
Total Liabilities and Equity	**¥ 176,647,286**	**¥ 176,635,836**	**$ 26,884,801**

See notes to the consolidated financial statements

F-2

Table of Contents

RECON TECHNOLOGY, LTD

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	For the Nine Months Ended March 31,		For the Three Months Ended March 31,		For the Nine Months Ended March 31,
	2010 RMB (Unaudited)	2011 RMB (Unaudited)	2010 RMB (Unaudited)	2011 RMB (Unaudited)	2011 U.S. Dollars (Unaudited)
Revenues					
Hardware	¥ 90,932,348	¥ 77,754,951	¥ 24,578,963	¥ 11,108,566	$ 11,834,668
Service	7,675,214	2,111,111	1,709,402		321,321
Software	226,496				
Total revenues	**98,834,057**	**79,866,062**	**26,288,365**	**11,108,566**	**12,155,989**
Cost of revenues	**56,007,688**	**50,332,089**	**14,538,530**	**9,123,575**	**7,660,780**
Gross margin	**42,826,369**	**29,533,973**	**11,749,835**	**1,984,991**	**4,495,209**
Selling and distribution expenses	7,557,188	6,545,509	1,534,090	1,449,192	996,257
General and administrative expenses	9,803,491	19,908,120	3,337,591	8,183,056	3,030,109
Operating expenses	**17,360,679**	**26,453,629**	**4,871,681**	**9,632,248**	**4,026,366**
Income (Loss) from operations	**25,465,690**	**3,080,344**	**6,878,153**	**(7,647,257)**	**468,843**
Other income (expenses)					
Subsidy income	1,178,034	792,545	20,000	341,025	120,629
Interest income	5,693	5,974		1,035	909
Interest expense	(32,074)	(159,171)	(21,335)	(85,872)	(24,227)
Interest expense related parties	(78,001)	(267,168)	(11,506)	(13,671)	(40,664)
Other income	471,914	289,605	389,668	284,546	44,079
Other income, net	1,545,566	661,785	376,827	527,063	100,726
Income (Loss) before income taxes and non-controlling interest	**27,011,256**	**3,742,129**	**7,254,979**	**(7,120,194)**	**569,569**
Provision for income taxes	7,189,566	1,561,897	2,082,801	174,898	237,728
Net income (loss) before allocation to non-controlling interests	**19,821,690**	**2,180,232**	**5,172,178**	**(7,295,092)**	**331,841**
Less: Net income attributable to non-controlling interest	(2,318,767)	(895,325)	(647,827)	(89,198)	(136,273)
Net income (loss) attributable to ordinary shareholders	**¥ 17,502,923**	**¥ 1,284,907**	**¥ 4,524,351**	**¥ (7,384,290)**	**$ 195,568**
Comprehensive income					
Net income (loss) before allocation to non-controlling interests	19,821,690	2,180,232	5,172,178	(7,295,092)	331,841

Foreign currency translation adjustment	119,992	(57,194)	119,992	(15,671)	(8,705)
Comprehensive income (loss)	**19,941,682**	**2,123,038**	**5,292,170**	**(7,310,763)**	**323,136**
Comprehensive income attributable to non-controlling interests	(2,330,766)	(889,606)	(659,826)	(87,631)	(135,403)
Comprehensive income attributable to ordinary shareholders	**¥ 17,610,916**	**¥ 1,233,432**	**¥ 4,632,344**	**¥ (7,398,394)**	**$ 187,733**
Earnings (Loss) per ordinary share - basic					
Net income (loss) attributable to ordinary shareholders	¥ 4.66	¥ 0.33	¥ 1.14	¥ (1.87)	$ 0.05
Earnings (loss) per ordinary share - diluted					
Net income (loss) attributable to ordinary shareholders	¥ 4.65	¥ 0.33	¥ 1.13	¥ (1.87)	$ 0.05
Weighted - average ordinary shares - basic	**3,753,350**	**3,951,811**	**3,951,811**	**3,951,811**	**3,951,811**
Weighted - average ordinary shares - diluted	**3,763,408**	**3,951,811**	**4,002,298**	**3,951,811**	**3,951,811**

See notes to the consolidated financial statements

F-3

Table of Contents

RECON TECHNOLOGY, LTD

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Nine Months Ended March 31,		
	2010 RMB (Unaudited)	2011 RMB (Unaudited)	2011 U.S. Dollars (Unaudited)
Cash flows from operating activities:			
Net income before allocation to non-controlling interests	**¥ 19,821,690**	**¥ 2,180,232**	**$ 331,841**
Adjustments to reconcile net income before non-controlling interests to net cash provided by (used in) operating activities:			
Depreciation	263,036	303,804	46,240
Stock based payment	1,178,701	1,138,264	173,249
Provision for doubtful debts		7,937,870	1,208,181
Movement of deferred taxation	1,329,433	(1,785,751)	(271,800)
Changes in operating assets and liabilities:			
Trade accounts receivable	(43,645,506)	6,345,495	965,814
Trade accounts receivable-related parties	7,458,302		
Other receivables	(4,517,417)	(11,774,622)	(1,792,153)
Other receivables related parties	507,541		
Purchase advance	(33,963,030)	30,275,498	4,608,075
Prepaid expense	(778,507)	(462,249)	(70,356)
Inventories	(2,442,053)	(24,493,492)	(3,728,024)
Deferred tax assets		(1,785,751)	(271,800)
Trade accounts payable	1,981,145	(1,677,029)	(255,252)
Trade accounts payable-related parties	(189,744)		
Other payables	840,619	(507,256)	(77,207)
Other payables-related parties	73,579		
Deferred income	1,822,916	(1,414,636)	(215,314)
Advances from customers	(884,565)	(439,761)	(66,934)
Accrued payroll and employees welfare	(96,439)	(242,978)	(36,982)
Accrued expenses	31,677	22,944	3,492
Taxes payable	9,701,746	1,166,484	177,544
Net cash provided by (used in) operating activities	**(41,506,877)**	**4,787,066**	**728,614**
Cash flows from investing activities:			
Purchases of property and equipment	(371,162)	(147,449)	(22,442)
Proceeds from sale of property and equipment	320		
Net cash used in investing activities	**(370,842)**	**(147,449)**	**(22,442)**
Cash flows from financing activities:			
Proceeds from stock issuance	60,209,057		
Proceeds from short-term bank loan		5,000,000	761,023
Proceeds from (Repayment to) short-term borrowings	459,089	(1,111,061)	(169,109)
Repayment to (Repayment to) short-term borrowings-related party	803,280	(4,068,852)	(619,298)
Net cash provided by (used in) financing activities	**61,471,426**	**(179,913)**	**(27,384)**
Effect of exchange rate fluctuation on cash and cash equivalents	**(28,514)**	**18,100**	**2,755**

Net increase in cash and cash equivalents	**¥**	**19,565,192**	**¥**	**4,477,804**	**$**	**681,543**
Cash and cash equivalents at beginning of period		2,727,735		12,142,957		1,848,215
Cash and cash equivalents at end of period	**¥**	**22,292,927**	**¥**	**16,620,761**	**$**	**2,529,758**
Supplemental cash flow information						
Cash paid during the period for interest	¥		¥	48,000	$	7,306
Cash paid during the period for taxes	¥	98,834	¥	2,344,515	$	356,846

See notes to the consolidated financial statements

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

Organization - Recon Technology, Ltd (the Company) was incorporated under the laws of the Cayman Islands on August 21, 2007 by Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (the Principal Shareholders) as a company with limited liability. The Company provides oilfield specialized equipment, automation systems, tools, chemicals and field services to petroleum companies in the People s Republic of China (the PRC). Its wholly owned subsidiary, Recon Technology Co., Limited (Recon-HK) was incorporated on September 6, 2007 in Hong Kong. Other than the equity interest in Recon-HK, the Company does not own any assets or conduct any operations. On November 15, 2007, Recon-HK established one wholly owned subsidiary, Jining Recon Technology Ltd. (Recon-JN) under the laws of the PRC. Other than the equity interest in Recon-JN, Recon-HK does not own any assets or conduct any operations.

The Company conducts its business through the following PRC legal entities that are consolidated as contractual subsidiaries and operate in the Chinese oilfield equipment & service industry:

Beijing BHD Petroleum Technology Co., Ltd. (BHD),

Nanjing Recon Technology Co., Ltd. (Nanjing Recon), and

Jining ENI Energy Technology Co., Ltd. (ENI)

Chinese laws and regulations currently do not prohibit or restrict foreign ownership in petroleum businesses. However, Chinese laws and regulations do prevent direct foreign investment in certain industries. On January 1, 2008, to protect the Company s shareholders from possible future foreign ownership restrictions, the Principal Shareholders, who also hold the controlling interest of BHD, Nanjing Recon and ENI, reorganized the corporate and shareholding structure of these entities by entering into certain exclusive agreements with Recon-JN, which entitles Recon-JN to receive a majority of the residual returns. On May 29, 2009 Recon JN and BHD, Nanjing Recon, and ENI entered into an operating agreement to provide full guarantee for the performance of such contracts, agreements or transactions entered into by BHD, Nanjing Recon, and ENI. As a result of the new agreement, Recon-JN will absorb 100% of the expected losses and receive 90% of the expected gains of BHD, Nanjing Recon, and ENI, which results in Recon-JN being the primary beneficiary of these Companies.

Recon-JN also entered into Share Pledge Agreements with the Principal Shareholders, who pledged all their equity interest in these entities to Recon-JN. The Share Pledge Agreements, which were entered into by each Principal Shareholder, pledged each of the Principal Shareholders equity interest in BHD, Nanjing Recon and ENI as a guarantee for the service payment under the Service Agreement.

The Service Agreement, entered into on January 1, 2008, between Recon-JN and BHD, Nanjing Recon, and ENI, states that Recon-JN will provide technical consulting services to BHD, Nanjing Recon, and ENI in exchange for 90% of their annual net profits as a service fee, which is to be paid quarterly.

F-5

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

In addition, Recon-HK entered into Option Agreements to acquire the Principal Shareholders equity interest in these entities if or when permitted by the PRC laws.

Based on these exclusive agreements, the Company consolidates BHD, Nanjing Recon and ENI as contractual subsidiaries as required by ASC Topic 810, *Consolidation* because the Company is the primary beneficiary.

On August 28, 2000 a Principal Shareholder of the Company purchased a controlling interest in BHD which was organized under the laws of the PRC on June 29, 1999. As of June 30, 2010 and March 31, 2011, the Principal Shareholders held 67.5% ownership in BHD. BHD is combined with the Company through the date of the exclusive agreements, and is consolidated following January 1, 2008, the date of the agreements based on ASC Topic 810. The Company allocates profits and losses 90% and 100%, respectively based upon the control agreements. Profits allocated to the minority interest is the remaining amount (10%).

On January 21, 2003, ENI was organized under the laws of the PRC. Principal Shareholders of the Company own a controlling interest of ENI. As of June 30, 2010 and March 31, 2011, the Principal Shareholders held 80% ownership interest in ENI. ENI is combined with the Company through the date of the exclusive agreements, and is consolidated following January 1, 2008, the date of the agreements based on ASC Topic 810. The Company allocates profits and losses 90% and 100%, respectively based upon the control agreements. Profits allocated to the minority interest is the remaining amount (10%).

On July 4, 2003, Nanjing Recon was organized under the laws of the PRC. On August 27, 2007 the Principal Shareholders of the Company purchased a majority ownership of Nanjing Recon from a related party who was a majority owner of Nanjing Recon. As of June 30, 2010 and March 31, 2011, the Principal Shareholders held 80% ownership interest in Nanjing Recon. Nanjing Recon is combined with the Company through the date of the exclusive agreements, and is consolidated following January 1, 2008, the date of the agreements based on ASC Topic 810. The Company allocates profits and losses 90% and 100%, respectively based upon the control agreements. Profits allocated to the minority interest is the remaining amount (10%).

Nature of Operations - The Company engaged in (1) providing equipment, tools and other hardware related to oilfield production and management. Simple installations may happen in connection with some projects; (2) developing and selling its own specialized industrial automation control and information solutions. The products and services provided by the Company include:

High-Efficiency Heating Furnaces - High-Efficiency Heating Furnaces are designed to remove the impurities and to prevent solidification blockage in transport pipes carrying crude petroleum. Crude petroleum contains certain impurities which include water and natural gas, that must be removed before the petroleum can be sold.

Multi-Purpose Fissure Shaper - Multipurpose fissure shapers improve the extractors ability to test for and extract petroleum which must be perforated into the earth before any petroleum extractor can test for the presence of oil.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Oil Field Water Finding/Blocking Technology - The Company developed this technology designed to find and block water content in petroleum.

Supervisory Control and Data Acquisition System (SCADA) - SCADA is an industrial computerized process control system for monitoring, managing and controlling petroleum extraction. SCADA integrates underground and above-ground activities of the petroleum extraction industry. This system can help to manage the oil extraction process in real-time to reduce the costs associated with extraction.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - The accompanying consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). The accompanying consolidated financial statements include the financial statements of the Company, its subsidiaries. All inter-company transactions and balances between the Company, its subsidiaries are eliminated upon consolidation. In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring entries, which are necessary for a fair presentation of the results for the interim periods presented. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Form 10-K for the fiscal year ended June 30, 2010. The results of operations for the interim periods presented are not indicative of the operating results to be expected for the Company s fiscal year ending June 30, 2011.

Reclassifications - Certain amounts have been reclassified to conform to the current presentation.

Principles of Consolidation - The consolidated financial statements include the financial statements of the Company and all the subsidiaries of the Company. All transactions and balances between the Company and its subsidiaries have been eliminated upon consolidation.

Currency Translation - The Company s functional currency is the Chinese Yuan (RMB) and the accompanying consolidated financial statements have been expressed in Chinese Yuan. The consolidated financial statements as of and for the nine months ended March 31, 2011 have been translated into United States dollars (U.S. dollars) solely for the convenience of the readers and are unaudited. The translation has been made at the rate of ¥ 6.5701= US$1.00, the approximate exchange rate prevailing on March 31, 2011. These translated U.S. dollar amounts should not be construed as representing Chinese Yuan amounts or that the Chinese Yuan amounts have been or could be converted into U.S. dollars.

Accounting Estimates - The preparation of the consolidated financial statements in conformity with U.S. GAAP requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Estimates are adjusted to reflect actual experience when necessary. Significant accounting estimates reflected in the Company s consolidated financial statements include revenue recognition, allowance for doubtful accounts, and useful lives of property and equipment. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates.

Fair Values of Financial Instruments - The carrying amounts reported in the consolidated balance sheets for trade accounts receivable, other receivables, purchase advances, trade accounts payable, accrued liabilities, advances from customers, short-term bank loan and short-term borrowings approximate fair value because of the immediate or short-term maturity of these financial instruments.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Cash and Cash Equivalents - Cash and cash equivalents are comprised of cash on hand, demand deposits and highly liquid short-term debt investments with stated maturities of no more than three months.

Trade Accounts and Other Receivables - Trade accounts receivable are recorded when revenue is recognized and are carried at original invoiced amount less a provision for any potential uncollectible amounts. Provision is made against trade accounts and other receivables to the extent they are considered to be doubtful. Other receivables are from transactions with non-trade customers.

Purchase Advances - Purchase advances are the amounts prepaid to suppliers for purchases of inventory and are recognized when the final amount is paid to the suppliers and the inventory is delivered.

Inventories - Inventories are stated at the lower of cost or market value, on a weighted average basis. The method of determining inventory costs is used consistently from year to year. Allowance for inventory obsolescence is provided when the market value of certain inventory items are lower than the cost.

Property and equipment - Property and equipment are stated at cost. Depreciation on motor vehicles and office equipment is computed using the straight-line method over the estimated useful lives of the assets, which range from two to ten years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the assets

Items	Useful life
Motor vehicles	10 Years
Office equipment	2-5 Years
Leasehold improvement	5 years

Long-lived Assets - The Company applies the Accounting Standards Codification (ASC) No. 360-10 Property, plant and equipment , ASC NO. 360 requires that long-lived assets, such as property and equipment and intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. Fair value is determined based on the estimated discounted future cash flows expected to be generated by the asset.

Advances from Customers - The Company, as is common practice in the PRC, will often receive advance payments from its customers for its products or service. The advances are showed as current liabilities and are recognized as revenue when the products are delivered or service is provided.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Revenue Recognition - The Company recognizes revenue when the following four criteria are met: (1) persuasive evidence of an arrangement, (2) delivery has occurred or services have been provided, (3) the sales price is fixed or determinable, and (4) collectability is reasonably assured. Delivery does not occur until products have been shipped or services have been provided to the client and the client has signed a completion and acceptance report, risk of loss has transferred to the client, client acceptance provisions have lapsed, or the Company has objective evidence that the criteria specified in client acceptance provisions have been satisfied. The sales price is not considered to be fixed or determinable until all contingencies related to the sale have been resolved.

Hardware:

Revenue from hardware sales is generally recognized when the product is shipped to the customer and when there are no unfulfilled company obligations that affect the customer s final acceptance of the arrangement.

Software:

The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with ASC No. 985 - 605 Software Revenue Recognition . Revenue from software is recognized according to project contracts. Contract costs are accumulated during the periods of installation and testing or commissioning. Usually this is short term. Revenue is not recognized until completion of the contracts and receipt of acceptance statements.

Services:

The Company provides services to improve software functions and system requirements on separated fixed-price contracts. Revenue is recognized on the completed contract method when acceptance is determined by a completion report signed by the customer.

Deferred income represents unearned amounts billed to customers related to sales contracts.

Cost of Revenues - When the criteria for revenue recognition have been met, costs incurred are recognized as cost of revenue. Cost of revenues include wages, materials, handling charges, the cost of purchased equipment and pipes and other expenses associated with manufactured products and service provided to customers.

Subsidy Income - The Company received grants of ¥20,000 and ¥341,025 ($51,906) from the local government for the three months ended March 31, 2010 and 2011, respectively. The Company received grants of ¥1,178,034 and ¥792,545 ($120,629) from the local government for the nine months ended March 31, 2010 and 2011, respectively. 1) Grants given by the government were to support local software companies operation and research and development. Grants related to research and development projects are recognized as subsidy income in the consolidated statements of operations when received. 2) Grants in form of value-added-tax refund for software products are recognized when received.

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Advertising expenses - Advertising expenses, which generally represent the cost of promotions to create or stimulate a positive image of the Company or a desire to buy the Company s products and services, are expensed as incurred. The Company incurred no advertising expenses in each of the periods presented.

Share-Based Compensation - The Company accounts for share-based compensation in accordance with ASC Topic.718, *Share-Based Payment*. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense with graded vesting on a straight line basis over the requisite service period for the entire award. The Company has elected to recognize compensation expenses using the Binomial Lattice valuation model estimated at the grant date based on the award s fair value

Income Taxes - Income taxes are provided based upon the liability method of accounting pursuant to ASC Topic 740, *Accounting for Income Taxes,* Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes. Deferred taxes are provided on differences between the tax bases of assets and liabilities and their reported amounts in the financial statements, and tax carry forwards. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The Company has not been subject to any income taxes in the United States or the Cayman Islands.

Business Segments - The Company operates in one industry which includes the sale of products for the oil field construction solely to customers in China; therefore, no business segment information has been presented.

Earnings (Loss) per Share - Basic earnings (loss) per share is computed by dividing net income (loss) available for ordinary shareholders by the weighted average number of ordinary shares outstanding. Diluted earnings (loss) per share are computed by dividing net income (loss) available for ordinary shareholders by the weighted-average number of ordinary shares and dilutive potential ordinary shares equivalents outstanding.

Recently Enacted Accounting Standards

In the quarter ended March 31, 2011, The Financial Accounting Standards Board (FASB) has issued ASU No. 2011-01 through ASU 2011-3, which is not expected to have a material impact on the consolidated financial statements upon adoption.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

NOTE 3. TRADE ACCOUNTS RECEIVABLE, NET

Trade accounts receivable consisted of the following at June 30, 2010 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Trade accounts receivable	¥ 90,515,321	¥ 85,277,218	$ 12,979,592
Allowance for doubtful accounts	(1,089,331)	(2,196,723)	(334,351)
Trade accounts receivable, net	¥ 89,425,990	¥ 83,080,495	$ 12,645,241

NOTE 4. OTHER RECEIVABLES, NET

Other receivables consisted of the following at June 30, 2010 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Deposit for purchasing inventory	¥ 7,930,268	¥ 17,757,920	$ 2,702,839
Loans to third party	3,723,982	6,277,242	955,425
Advance to staff	1,186,807	482,798	73,484
Deposit for project	80,000	180,080	27,409
Others	83,547	81,186	12,357
Allowance for doubtful accounts	(154,057)	(6,984,535)	(1,063,079)
Other receivables, net	¥ 12,850,547	¥ 17,794,691	$ 2,708,435

Deposit for purchasing inventory was ¥7,930,268 and ¥17,757,920 ($2,702,839) as of June 30, 2010 and March 31, 2011, respectively. It represents that Company paid to certain agents designated by the ending customers to purchase special inventory.

Loans to third party are mainly used for short-term fund to support cooperative companies, most of them are our customers. These loans are due on demand without interest bearing.

Advances to staff are for business travel and sundry expenses related to oil field or on-site installation and inspection of products until the test running is normal or contract technical requirements are finished.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

NOTE 5. PURCHASE ADVANCES

Purchase advances consisted of the following at June 30, 2010 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Prepayment for purchasing inventory	¥ 46,293,094	¥ 16,878,362	$ 2,568,966
Service fee	258,308		
Purchase advances	¥ 46,551,402	¥ 16,878,362	$ 2,568,966

NOTE 6. INVENTORIES

Inventories consisted of the following at June 30, 2010 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Low-value consumption goods	¥ 310,381	¥ 43,420	$ 6,609
Purchased goods and raw materials	5,721,871	220,158	33,509
Work in process		472,162	71,865
Finished goods	7,118,659	36,908,663	5,617,671
Total inventories	¥ 13,150,911	¥ 37,644,403	$ 5,729,654

NOTE 7. OTHER PAYABLE

Other payable consisted of the following at June 30, 2010 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Loans from third-party companies	¥ 2,183,965	¥	$
Loans from third-party individuals	223,448		
Rental	441,921	66,808	10,168
Freight		2,471,805	376,221
Expenses paid by third-parties on behalf of Recon	194,361	50,313	7,658
Service		127	19

Others	52,614		
Total other payable	¥ 3,096,309	¥ 2,589,053	$ 394,066

Loans from third-party companies were mainly borrowed for supplemental working capital by BHD with amount of ¥1,100,000 and Nanjing Recon of ¥1,083,965 as of June 30, 2010. These loans are due on demand without interest bearing. As of March 31, 2011, such loan was reclassified to short-term borrowings in note 12.

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

NOTE 8. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30 and March 31, 2011:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Motor vehicles	¥ 1,796,955	¥ 1,919,555	$ 292,165
Office equipment and fixtures	450,715	475,564	72,383
Leasehold improvement	426,181	426,181	64,867
Total property and equipment	2,673,851	2,821,300	429,415
Less: Accumulated depreciation	(1,190,970)	(1,494,774)	(227,512)
Property and equipment, net	¥ 1,482,881	¥ 1,326,526	$ 201,903

Depreciation expense was ¥92,172 and ¥ 100,526 ($15,301) for the three months ended March 31, 2010 and 2011, respectively. Depreciation expense was ¥263,036 and ¥303,804 ($46,240) for the nine months ended March 31, 2010 and 2011 respectively.

NOTE 9. SHAREHOLDERS EQUITY

Ordinary Shares - When the Company was incorporated in the Cayman Islands on August 21, 2007, 25,000,000 ordinary shares were authorized, and 2,139,203 ordinary shares were issued to the Principal Shareholders, at a par value of $0.0185 each. On July 29, 2009, the Company completed its IPO by offering 1,700,000 ordinary shares at $6.00 per share. After this IPO, all the 112,608 redeemable ordinary shares outstanding were automatically converted into non-redeemable ordinary shares pursuant to the Agreement. On July 31, 2009 ordinary shares of the Company commenced trading on NASDAQ Exchange. The Company has 3,951,811 ordinary shares issued and outstanding on July 31, 2009 and March 31, 2011.

Appropriated Retained Earnings - According to the Articles of Incorporation, the Company is required to transfer a certain portion of its net profit, as determined under PRC accounting regulations, from current net income to the statutory reserve fund. In accordance with the PRC Company Law, the Companies are required to transfer 10% of their profit after tax, as determined in accordance with PRC accounting standards and regulations, to the statutory reserves until such reserves reach 50% of the registered capital or paid-in capital of the Companies. As of June 30, 2010 and March 31, 2011 the balance of total statutory reserves was ¥3,755,503 and ¥4,396,641($669,189), respectively.

Share-based Awards Plan - In June 2009, the Board of Directors and the shareholders of the Company adopted the 2009 Stock Incentive Plan (the 2009 Plan). The 2009 Plan provides for the granting of share options and restricted ordinary shares to employees, non-employee directors and consultants of the Company. Options granted under the 2009 Plan may be Incentive Stock

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Options or Non-statutory Stock Options. Non-employee directors and Consultants are not eligible to receive the award of an Incentive Stock Option. The Compensation Committee of the Board of Director is entitled to establish the term, vesting conditions and exercise price of the options as well as the vesting conditions and transferability of restricted shares. Under the 2009 Plan, 790,362 unissued ordinary shares have been reserved for issuance. As discussed in Note 16, under the 2009 Plan, the Company granted options to purchase 293,000 of ordinary shares to its employees and non-employee directors on July 29, 2009 and 170,000 warrants to placement agent.

On December 31, 2010, the Company held the annual board meeting and accepted resignation of some directors. Based on the Company s stock incentive plan, no options may be exercised more than 3 months after termination of employment. Since those directors left at the time of the annual meeting in December, their options had expired as of March 31, 2011. Thus, corresponding 100,000 options went back into the Company s incentive pool.

NOTE 10. INCOME TAXES

The Company is not subject to any income taxes in the United States or the Cayman Islands and had minimal operations in jurisdictions other than the PRC. ENI, BHD and Nanjing Recon are subject to PRC s income taxes as PRC domestic companies.

According to the implementation of the new Enterprise Income Tax Law (EIT Law), income tax rate for ENI was 25% in calendar year 2008 and thereafter.

According to the implementation of the new Enterprise Income Tax Law (EIT Law), Nanjing Recon is subject to an income tax rate of 25%. For calendar year 2010, Nanjing Recon was recognized as a high-tech company, thus it is subject to an income tax rate of 15% for three years since 2010.

As approved by the domestic tax authority in the PRC, BHD was recognized as a government-certified high technology company on November 25, 2009 and is subject to an income tax rate of 15% for three years since 2009. This qualification certificate will stay effective till the certificate matures in 2011.

Deferred taxes are comprised of the following:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Allowance for doubtful receivables	¥ 275,960	¥ 2,061,711	$ 313,802
Total deferred income tax assets	¥ 275,960	¥ 2,061,711	$ 313,802

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

Following is a reconciliation of income taxes at the calculated statutory rates:

	For the Three Months Ended March 31, 2010 RMB (Unaudited)	For the Three Months Ended March 31, 2011 RMB (Unaudited)	For the Three Months Ended March 31, 2011 U.S. Dollars (Unaudited)
Income tax calculated at statutory rates	¥ 2,233,449	¥ 291,496	$ 44,367
Nondeductible expenses (non-taxable income)			
Benefit of favorable rate for high-technology companies	503,223	(116,598)	(17,747)
Benefit of operating loss carry forwards	(653,871)		
Benefit of revenue exempted from enterprise income tax			
Provision for income taxes	¥ 2,082,801	¥ 174,898	$ 26,620

	For the Nine Months Ended March 31, 2010 RMB (Unaudited)	For the Nine Months Ended March 31, 2011 RMB (Unaudited)	For the Nine Months Ended March 31, 2011 U.S. Dollars (Unaudited)
Income tax calculated at statutory rates	¥ 7,994,081	¥ 2,789,070	$ 424,510
Nondeductible expenses (non-taxable income)		7,337	1,117
Benefit of favorable rate for high-technology companies	(150,646)	(1,115,628)	(169,805)
Benefit of operating loss carry forwards	(653,869)		
Benefit of revenue exempted from enterprise income tax		(118,882)	(18,094)
Provision for income taxes	¥ 7,189,566	¥ 1,561,897	$ 237,728

The provision for income taxes is comprised of the following:

	For the Three Months Ended March 31, 2010 RMB	For the Three Months Ended March 31, 2011 RMB	For the Three Months Ended March 31, 2011 U.S. Dollars

	(Unaudited)	(Unaudited)	(Unaudited)
Current income taxes	¥ 9,697,717	¥ 174,898	$ 26,620
Deferred income taxes	(7,614,916)		
Provision for income taxes	¥ 2,082,801	¥ 174,898	$ 26,620

Table of Contents

RECON TECHNOLOGY, LTD

NOTES TO THE CONSOLIDATED STATEMENTS (UNAUDITED)

	For the Nine months Ended March 31, 2010 RMB (Unaudited)	For the Nine months Ended March 31, 2011 RMB (Unaudited)	For the Nine months Ended March 31, 2011 U.S. Dollars (Unaudited)
Current income taxes	¥ 10,884,224	¥ 1,561,897	$ 237,728
Deferred income taxes	(3,694,658)		
Provision for income taxes	¥ 7,189,566	¥ 1,561,897	$ 237,728

NOTE 11. SHORT-TERM BANK LOAN

Short-term bank loan consist of the following:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Beijing Bank, with a floating interest rate (CHIBOR) from 5.81% to 6.06% annually, mature on December 21, 2011	¥	¥ 5,000,000	$ 761,023
Short-term bank loan	¥	¥ 5,000,000	$ 761,023

The interest expenses for Short-term bank loan are ¥0 and ¥ 73,068 ($11,121) for the three months ended March 31, 2010 and 2011, respectively, and are ¥0 and ¥73,068 ($11,121) for the nine months ended March 31, 2010 and 2011, respectively.

NOTE 12. SHORT-TERM BORROWINGS

Short-term borrowings consist of the following:

	June 30, 2010 RMB	March 31, 2011 RMB (Unaudited)	March 31, 2011 U.S. Dollars (Unaudited)
Short-term borrowings due to non-related parties:			
Due-on-demand borrowing, no interest	¥ 1,224,888	¥ 1,933,553	$ 294,296
Short-term borrowings, no interest, matures on Aug. 25, 2011	140,000	140,000	21,309
Short-term borrowings, interest at 6%, matures on Dec. 11, 2011	1,172,911	1,243,285	189,234
Short-term borrowings, no interest, matures on Dec. 27, 2011	411,500		

The senior secured loan agreement and related security agreement contain a number of restrictions that will require us to maintain certain financial ratios and limit our ability, among other things, to borrow money, pledge our inventory or other assets as security in other borrowings or transactions, undergo a merger or consolidation, guarantee certain obligations of third parties, make or extend credit other than on ordinary terms in the course of our business or engage in any activity not reasonably related to those we presently conduct.

We were in compliance with all of our covenants under the loan agreement as of December 31, 2006 and June 30, 2007. As of December 31, 2006 and June 30, 2007, we had remaining obligations of $9.1 and $14.3 million, respectively, to repay amounts outstanding under the loan agreement. We refinanced amounts outstanding under the revolving facility portion of our senior secured loan agreement in August 2007 when we entered into our new revolving credit agreement.

Revolving Credit Agreement

In August 2007, we entered into a new revolving credit agreement to replace the revolving credit facility under the senior secured loan agreement. We can borrow up to $25.0 million under the new agreement, which expires on August 10, 2012. Amounts outstanding under the new revolving credit agreement bear interest at a per annum rate equal to BBA LIBOR (equal to one-month LIBOR (reset on the 10^{th} of the month), subject to adjustments in certain circumstances) plus the Applicable Margin (as defined in the revolving credit agreement). The Applicable Margin depends on the Funded Debt to EBITDA Ratio (as defined in the agreement), and can range from 0.50% to 1.00%. The agreement permits letters of credit to be drawn in an aggregate amount of $5.0 million and has no mandated payment provisions. We are required to pay an unused commitment fee of 0.125% per annum on undrawn amounts under the agreement.

The revolving credit agreement and related security agreement contain a number of restrictions that will require us to maintain certain financial ratios and limit our ability, among other things, to borrow money, pledge our inventory or other assets as security in other borrowings or transactions, undergo a merger or consolidation, guarantee certain obligations of third parties, make or extend credit other than on ordinary terms in the course of our business or engage in any activity not reasonably related to those we presently conduct.

Issuance of Preferred Stock

In December 2004, funds managed by TA Associates purchased 7,952,018 shares of series A convertible preferred stock, par value $0.01, for $35.0 million. In connection with this sale, we declared a 150,000:1 common stock dividend to increase the number of common shares held by Tom from 100 to approximately 15.0 million. The stock split was effected in order to ensure that Tom would continue to hold an appropriate percentage of our common stock upon conversion of the convertible preferred stock held by TA Associates on a 1 for 1 basis. We distributed $42.6 million in cash to Tom in 2004, including $30.0 million of the proceeds from the sale of the convertible preferred stock (which represented a significant dilution of his ownership interest), $5.0 million to enable him to pay taxes on deemed income during the period we were an S corporation and $7.6 million of additional cash. We retained $5.0 million of cash from the sale of our Series A convertible preferred stock for general working capital

Table of Contents

purposes and to provide operating liquidity. As a result of those cash distributions, we had a total stockholder s deficit of $30.2 million as of December 31, 2004, which has steadily improved to a stockholder s deficit of $0.0 million as of June 30, 2007. In connection with this offering, TA Associates has agreed to convert all of the outstanding shares of series A convertible preferred stock that it holds into shares of common stock. For additional information about the investment by TA Associates, see Certain Relationships and Related Party Transactions Investment by TA Associates.

Related Party Transactions

Tom Sullivan is the sole owner of ANO LLC, DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and he has a 50% membership interest in BMT Holdings, LLC (collectively, ANO and Related Companies). We leased our Toano facility, which includes a store location, and 25, 22 and 12 of our other store locations from these entities as of December 31, 2006, 2005 and 2004, representing 28.6%, 30.3% and 22.8% of total store leases, respectively. As of September 30, 2007, we leased our Toano facility and 26 of our other store locations from these entities, representing 27% of total store leases. The operating lease for our Toano facility has a base period through December 31, 2019. See Certain Relationships and Related Party Transactions.

Contractual Commitments and Contingencies

Our significant contractual obligations and commitments as of December 31, 2006 and June 30, 2007 are summarized in the following tables:

		Payments Due by Period			
	Total	Less Than 1 Year	1 to 3 Years	3 to 5 Years	5+ Years
			(in thousands)		
Contractual obligations(1)					
As of December 31, 2006					
Debt obligations	$ 9,283	$ 2,804	$ 4,009	$ 2,470	$
Variable rate interest on debt obligations(2)	1,127	463	556	108	
Operating lease obligations(3)	31,384	5,548	9,463	5,531	10,842
Capital lease obligations, including interest(3)	330	269	61		
Supplier purchase commitments(4)	68,185	11,560	42,798	13,827	
Total contractual obligations	$ 110,309	$ 20,644	$ 56,887	$ 21,936	$ 10,842

		Payments Due by Period			
	Total	Less Than 1 Year	1 to 3 Years	3 to 5 Years	5+ Years
			(in thousands)		
Contractual obligations(1)					
As of June 30, 2007					
Debt obligations	$ 14,368	$ 8,906	$ 3,980	$ 1,482	$
Variable rate interest on debt obligations(5)	881	404	431	46	
Operating lease obligations(3)	38,086	6,704	11,174	7,224	12,984
Capital lease obligations, including interest(3)	166	148	18		
Supplier purchase commitments(4)	47,959	13,253	31,282	3,424	
Total contractual obligations	$ 101,460	$ 29,415	$ 46,885	$ 12,176	$ 12,984

(1) This table excludes the $35.0 million redemption amount of our series A convertible preferred stock. This table includes amounts outstanding under our term loan, in accordance with its maturity schedule, as set forth in our senior secured loan agreement. Upon consummation of this offering, the term loan will be repaid in full.

48

Table of Contents

(2) As of December 31, 2006, our senior secured loan agreement accrued interest at a rate of one-month LIBOR plus 0.90%, and the rate at which we accrued interest was 6.2%. We estimated our obligation under this agreement by assuming that interest will accrue at the December 31, 2006 rate until the loan agreement expires.

(3) Included in this table is the base period or current renewal period for our operating leases. We lease certain buildings and equipment under non-cancelable operating leases and certain transportation equipment under non-cancelable capital leases. The leases expire at various dates through 2017 (2019 in the case of the lease for our Toano facility). The operating leases generally contain renewal provisions for varying periods of time.

(4) We have one long-term purchase agreement with a merchant vendor that we entered into in July 2006 that requires us to purchase approximately 27 million square feet of product over a four-year period ending August 2010. The agreement provides for a set menu of products, including prices and specifications, from which we can pick in placing our orders, and provides for a detailed process by which either party can request a change in prices or specifications, or add or delete products from the menu. In the table above, our commitment for less than one year was calculated using actual purchase commitments, while the commitment for subsequent years was calculated using our actual commitments, where applicable, plus our estimated remaining commitments under that agreement.

(5) As of June 30, 2007, our senior secured loan agreement accrued interest at a rate of one-month LIBOR plus 0.90%, and the rate at which we accrued interest was 6.2%. We estimated our obligation under this agreement by assuming that interest will accrue at the June 30, 2007 rate until the loan agreement expires.

Off-Balance Sheet Arrangements

We currently do not have any off-balance sheet arrangements or other financing activities with special-purpose entities.

Qualitative and Quantitative Disclosures About Market Risk

Interest Rates. Because our senior secured loan agreement and our new revolving credit agreement bear interest at a variable rate, we are exposed to market risks relating to changes in interest rates. Both agreements, which we expect to repay in full upon completion of this offering, bear interest at a variable rate, adjusted annually, based on our performance under certain specified operating ratios. From inception at March 23, 2006 to June 30, 2007, our outstanding loans bore interest at a per annum rate equal to one-month LIBOR plus 0.90%. A hypothetical 100 basis-point increase from the current interest level on $14.3 million, the amount outstanding under our senior secured loan agreement at June 30, 2007, would result in approximately a $0.1 million increase in interest expense over a one-year period. A hypothetical 100 basis-point decrease from the current interest level would result in approximately a $0.1 million decrease in interest expense over a one-year period. We currently do not engage in any interest rate hedging activity and currently have no intention to do so in the foreseeable future. However, in the future, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

Inflation

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross profit and selling, general and administrative expenses as a percentage of net sales if the selling prices of our products do not increase with these increased costs.

Table of Contents

Critical Accounting Policies and Estimates

Critical accounting policies are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements:

Recognition of Net Sales

We recognize net sales for products purchased at the time the customer takes possession of the merchandise. We recognize service revenue, which consists primarily of freight charges for in-home delivery, when the service has been rendered. Net sales are reduced by an allowance for anticipated sales returns that we estimate based on historical sales trends and experience. Any reasonably likely changes that may occur in the assumptions underlying our allowance estimates would not be expected to have a material impact on our financial condition or operating performance. In addition, customers who do not take immediate delivery of their purchases are generally required to leave a deposit of up to 50% of the sales amount with the balance payable when the products are delivered. These customer deposits benefit our cash flow and return on investment capital, since we receive partial payment for our customers purchases immediately. We record these deposits as a liability on our balance sheet under the line item Customer Deposits and Store Credits until the customer takes possession of the merchandise.

Equity Compensation

We maintain several equity incentive plans under which we may grant non-qualified stock options and incentive stock options to employees and non-employee directors. Using the prospective-transition method, we adopted the provisions of SFAS 123 (R) effective January 1, 2006. Prior to the adoption of SFAS 123 (R), we used the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25 (or APB 25). There were no material differences in the calculations of stock-based compensation expense under APB 25 and SFAS 123, Accounting for Stock-Based Compensation in 2005 or 2004. We recognize expense for our stock-based compensation based on the fair value of the awards that are granted. Measured compensation cost is recognized ratably over the service period of the related stock-based compensation award.

The fair value of stock options was estimated at the date of grant using the Black-Scholes-Merton valuation model. In order to determine the related stock compensation expense, we used the following assumptions:

Expected life of 7.5 years;

Expected stock price volatility of between 35% and 39%, based on the median volatility of companies in a peer group;

Risk-free interest rates from 4.6% to 5.2%; and

Dividends are not expected to be paid in any year.

In addition, we are party to the Variable Plan, a stock-based agreement between Tom Sullivan and Kevin Sullivan, pursuant to which we generally guarantee Tom s cash payment obligation under the agreement. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended in August 2005, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria

50

Table of Contents

(primarily a comparison of the net income of the region under his management to our total net income on a trailing twelve-month basis). In order to determine the compensation expense to be recorded, we are required to determine the net income of the region under his management, which requires us to make certain estimates.

Management estimated the fair value of our common stock based on contemporaneous valuations utilizing a market-approach model, developed by an independent third party and reviewed in detail by management. We used this approach to value our common stock in retrospectively determining stock-based compensation expense as of December 31, 2003, 2004 and 2005, and to establish contemporaneous fair values of equity instruments for our equity grants in 2006 and April 2007. For the second quarter of 2007, however, management determined that the IPO process had progressed to such an extent that a different valuation methodology (based on estimating the company s fair value as a public entity, and then applying a marketability discount) could be used to measure fair value, and accordingly used that methodology in determining stock compensation expense for that quarter. In calculating stock compensation expense for the quarter ended September 30, 2007, we intend to use that different methodology. We will make valuation determinations for the option grants and restricted stock unit grants that will be made in connection with the IPO using the actual IPO price, and thereafter expect to use the market value of the common stock on any date on which any such determination is required to be made.

A variety of qualitative and quantitative factors were considered in making these equity valuation determinations, including the state of the economy and the industry in which we operate, milestones that the company and its management had achieved and the appropriate marketability discount. We discuss our market and our achievements to date elsewhere in this prospectus, including in the sections entitled Management s Discussion and Analysis of Financial Condition and Results of Operations and Business . A marketability discount was also applied in each case, which management determined to be reasonable for each period based on the company s prospects for liquidity at that time and developments in its business and operations. This discount decreased over time as we improved various aspects of our business and operations, including moving to a new facility, increasing the size of our product range, opening a significant number of new stores, hiring a number of key senior executives (including a new CEO), and implementing a number of operational, financial and governance policies to enhance our reporting and compliance functions.

We have not granted any stock options since April 2007. As of June 30, 2007, there were 1,846,847 stock options outstanding (including 50,000 stock options granted in April 2007), with an aggregate intrinsic value of $10.6 million. See Note 4 to our unaudited interim financial statements included elsewhere in this prospectus. Based on the midpoint of the estimated IPO price range, the intrinsic value of the stock options outstanding at September 30, 2007 would have been $ million.

Merchandise Inventories

We value our merchandise inventories at the lower of merchandise cost or market value. We determine merchandise cost using the average cost method. All of the hardwood flooring we purchase from suppliers is either prefinished or unfinished, but is in immediate saleable form. To the extent that we finish and box unfinished products, we include those costs in the average unit cost of related merchandise inventory. In determining market value, we make judgments and estimates as to the market value of our products, based on factors such as historical results and current sales trends. Any reasonably likely changes that may occur in those assumptions in the future may require us to record charges for losses or obsolescence against these assets, but would not be expected to have a material impact on our financial condition or operating performance.

Table of Contents

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of January 1, 2007. The adoption of FIN 48 did not have a material effect on our financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the impact of SFAS 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (fair value option) and to report in earnings unrealized gains and losses on those items for which the fair value has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 will be effective for us as of the first quarter of 2008. Early adoption is permitted. We are currently evaluating the impact of SFAS 159 on our financial statements.

Table of Contents

BUSINESS

Overview

Lumber Liquidators is the largest specialty retailer of hardwood flooring in the United States, measured by total sales and based on information from *Floor Covering Weekly* and *Floor Focus* and our industry experience. We believe we have achieved a reputation for offering great value, superior service and a broad selection of high-quality hardwood flooring products. We offer an extensive selection of premium hardwood flooring products under multiple proprietary brands at everyday low prices designed to appeal to a diverse customer base. We believe that our vertically integrated business model enables us to offer a broad assortment of high-quality products to our customers at a lower cost than our competitors. We purchase prefinished and unfinished flooring directly from mills or associated brokers and work with our suppliers to control costs, develop new products and ensure superior product quality. Approximately 80% of our sales are to existing homeowners engaged in remodeling projects, and the remainder are to small independent contractors engaged in remodeling and new home building projects. As of September 30, 2007, we sold our products through 111 Lumber Liquidators stores in 42 states, a call center, our website and a catalog. We believe that our brands, value proposition and integrated multi-channel approach are important competitive advantages.

We offer hardwood flooring products from more than 25 domestic and exotic wood species in both prefinished and unfinished brands of various widths and lengths. Our products are differentiated in terms of quality and price based on the species, grade of the hardwood, quality of finishing, as well as the length of the warranty. We also offer a broad assortment of flooring enhancements and installation accessories including moldings, noise-reducing underlays and adhesives. Our product offering is substantially comprised of our proprietary brands, including our premium Bellawood brand as well as our Builder s Pride, Virginia Mill Works, Schôn, Morning Star Bamboo and Dream Home brands. We have experienced strong historical growth, including our net sales growth from $171.8 million in 2004 to $332.1 million in 2006 and operating income growth from $7.2 million in 2004 to $21.4 million in 2006 and net income growth from $8.0 million in 2004 to $12.9 million in 2006, representing compound annual growth rates of approximately 39%, 73% and 27%, respectively. In the first six months of 2007, our net sales were $197.7 million, which represents a 20% increase over the first six months of 2006. Our operating income for the first six months of 2007 declined to $7.7 million from $13.8 million in the first six months of 2006, and our net income declined to $4.6 million from $8.4 million for the same periods. Our overall growth has been driven in large part by the opening of 86 stores since January 1, 2003 and our strong comparable store sales performance in each of those periods. On an annual basis, comparable store sales increased 19.0% from 2004 to 2005, and 17.3% from 2005 to 2006. In the first six months of 2007, comparable store sales increased 8.8% over the first six months of 2006, which increased 23.1% over the first six months of 2005.

Our company started in 1994 when Tom Sullivan, the chairman of our board of directors, began selling discounted building materials. In 1996, he identified an opportunity to sell hardwood flooring at liquidator prices. Tom started selling unsold flooring products sourced directly from mills from a warehouse in Stoughton, Massachusetts, and in 1996, he opened the first Lumber Liquidators store near Boston, Massachusetts. Tom observed that traditional home improvement and flooring retailers underserved customers in terms of price, selection, product quality and overall value. Tom began working directly with vendors and mills to provide customers with broad, high-quality assortments at everyday low prices including in premium categories. He also identified the opportunity to better serve customers by employing knowledgeable sales staff to educate the customer about the product and provide advice on self-installation or working with contractors. In August 1996, Tom opened the second Lumber Liquidators store in Hartford, Connecticut, starting our company s national expansion. In 2000, we opened a central warehouse in Virginia and started operating our own finishing line. We subsequently moved to our current location in Toano, Virginia in 2004. The Toano facility contains our distribution

Table of Contents

center and finishing line, where we currently finish approximately 70% of our premium Bellawood products. We maintain our in-house finishing capability to ensure product quality and to reduce third-party finishing costs.

We have made a significant investment in developing our national brands, including our portfolio of proprietary product offerings. We believe Lumber Liquidators is now recognized across the United States as a destination for high-quality hardwood flooring at everyday low prices, while our Bellawood brand is known as a premium flooring brand within the industry. We have developed a national store presence, with 111 locations in 42 states as of September 30, 2007. Our stores typically consist of a warehouse and an attached showroom located in industrial or commercial areas that have lower rents than traditional retail locations, are accessible from major roadways and have significant visibility to passing traffic. Our average store is approximately 6,400 square feet, of which approximately 800 square feet is devoted to the showroom selling area. We have designed our stores using a visually appealing and distinctive showroom format to enhance the customer experience while demonstrating our low-cost approach to doing business. Most of our stores have wall racks holding one-foot by two-foot display boards of our flooring products and a warehouse stocked with our most popular hardwood products and high-volume items. Each of our store associates participates in all aspects of our store operations and is trained to understand the characteristics and installation method for the broad range of hardwood floors in order to best educate our customers. We do not, however, provide installation services. We believe that our stores reinforce our customers belief that they get a good deal when they buy from us.

Competitive Strengths

We believe the following competitive strengths contribute to our leading market position, differentiate us from our competition and will drive our future growth.

Attractive Store Economics

We operate a store model that produces strong returns on investment by combining low capital investment, a small store footprint, minimal staffing and a high average sale of more than $1,750 in 2006. We define average sale as the average invoiced sale per customer, measured on a monthly basis and excluding transactions of less than $250 (which are generally sample orders, or add-ons or fill-ins to previous orders) and of more than $30,000 (which are usually contractor orders). Our average new store across our markets has historically become profitable within three months of beginning operations and returned its initial cash investment within seven months. We estimate that the cost required to open a typical new store is approximately $240,000, of which inventory, net of trade payables, represents approximately $190,000. Our store model targets a pre-tax return on invested capital in excess of 140% for stores open more than three years (including all advertising costs). For the twelve months ended June 30, 2007, we did not have an unprofitable store on a four-wall basis in our portfolio (excluding stores open for less than three months). When measuring profitability on a four-wall basis, we take into account the sales and costs of sales at each individual store, as well as the expenses of that store, which include wages and benefits, rent and local advertising. We do not consider national advertising and store support costs, including those related to corporate overhead and our distribution facility, when calculating profitability on a four-wall basis. We believe the profitability of our store model is driven in part by our ability to carry broad product assortments, while maintaining limited in-store inventories. With the exception of certain high-volume products, we have found that customers typically give us a deposit for their purchases and request delivery of their products approximately one month after placing an order, which reduces our store-level working capital investment requirements and allows us to centrally manage inventory from our distribution facility in Toano. We initiate shipment of most products to a store after an order is placed by a customer, and we can time deliveries to meet our customers specific circumstances. In cases where the customer orders for future delivery, we generally receive a

Table of Contents

50% deposit, which benefits our cash flow and return on investment capital, because we receive immediate partial payment.

Appealing Value Proposition

Our value proposition to the customer is a key driver of our business. Important components include:

Price. A fundamental part of our founding philosophy is to provide quality hardwood flooring brands at everyday low prices. We are able to maintain these prices across our product range because, unlike a majority of our competitors, we purchase our flooring directly from mills and associated brokers, thereby avoiding mark-ups by distributors. In addition, we operate a low-cost store model with a no frills showroom, limited in-store inventory and locations in industrial or commercial areas that are easily accessible and visible to passing traffic and carry lower rent expense than many retail stores.

Selection. We have developed a broad product assortment of domestic and exotic hardwoods sold under proprietary brands that help us to differentiate our products from those of our competitors. We offer products across a range of price points and quality levels that allow us both to target discrete market segments and to appeal to diverse groups of customers. For example, we sell our Bellawood products to more affluent customers, while our engineered and laminate products are more popular with people seeking more economical flooring solutions.

Quality. We believe that we have achieved a reputation for quality, and that our proprietary brands are recognized for excellence by our customers. We work directly with our supplier mills and brokers to produce flooring that will meet our high quality standards. We require our suppliers to prepare most of the products we sell to our specifications. We also currently finish approximately 70% of our premium Bellawood products at our state-of-the-art Toano facility. We maintain an in-house inspection and quality control function and enforce strict certification requirements for Bellawood supplier mills. As a result, we offer a 50-year residential warranty on our premier Bellawood brand, which we believe is the industry s longest. The multiple coats of natural stains and urethane-based sealers that we apply to Bellawood results in a product with one of the highest scuff resistant finishes in the industry. We monitor the consistency of products produced by our suppliers and work with them to maintain high milling standards.

Availability. Since our founding, we have made it a priority to build long-term relationships with our key supplier mills and brokers. As we have grown, we believe our relationships with our suppliers have strengthened, which we believe helps us ensure our continued access to a broad selection of domestic and exotic hardwood products at attractive prices. In evaluating suppliers, one of the factors we consider is their access to new or hard-to-find species of wood, so that we can continue to expand our range of exotic hardwood products. We also seek out new mills that can meet our demanding standards, and we work with them to evaluate new hardwood species as well as new technologies that may allow us to expand or improve our operations. We believe that these direct supplier relationships are relatively unique in our industry, and offer us a significant competitive advantage. In addition, our centralized inventory at our Toano distribution facility allows us to deliver products not stocked in stores to our customers within a week of purchase or whenever it meets our customers specific needs. Approximately 85% of our merchandise passes through this facility before we move it to our stores. We believe our supply chain and centralized inventory allow us to meet the delivery needs of our customers better than our competitors.

Table of Contents

Established National Brands

We believe both Lumber Liquidators and Bellawood are well-known national brands. We have positioned Lumber Liquidators to represent an attractive value proposition to the customer, and believe we offer superior service and hardwood flooring expertise for customers seeking information about hardwood flooring. Based on our market research, we believe that Bellawood, which accounted for approximately one-third of our 2006 net sales, is among the most-recognized brands in the hardwood flooring industry. We are committed to supporting our brands and products through diverse national marketing campaigns, which have historically included TV, radio and print ads, as well as sports and television show sponsorships, including sponsoring a NASCAR truck racing team and television shows like Extreme Makeover: Home Edition and This Old House, that reach a wide variety of potential customers. In addition, we believe that we benefit from our long-term endorsement relationships with respected and well-known home improvement celebrities such as Bob Vila and Ty Pennington. Bob Vila has been associated with the Bellawood brand for several years, and Lumber Liquidators is the exclusive provider for that product. Ty Pennington, the star of Extreme Makeover: Home Edition, appeals to a younger demographic and is associated with the Lumber Liquidators and Bellawood brands, as well as with the signature Ty Pennington flooring brand that features a Bellawood finish and is sold exclusively in our stores.

Integrated Multi-Channel Sales Model

We have an integrated multi-channel sales model that enables our national store network, call center, website and catalog to work together in a coordinated manner. Due to the average size of the sale, many of our customers conduct extensive research before making a purchase decision. Our sales strategy emphasizes customer service by providing superior convenience and education tools for our customers to learn about our products and the installation process. Customers can view our complete assortment of products through each channel. We believe that potential new customers generally first come to know about us through our national advertising and other marketing efforts. For many of them, the next stop is our website, which provides an informational tool where they can start to learn about our wide variety of products. Our website also allows new customers to see before and after examples from previous customers, explains the installation process and provides product reviews and endorsements. Some customers also contact our call center, which is staffed by more than 50 flooring experts who are also available for online chat and email. Customers can order samples or a catalog through any of our sales channels. Customers who are ready to make a purchase can either visit one of our stores or place an order via our website or call center. We hire store associates who often have relevant industry experience, are able to guide customers through the purchasing process and can provide advice on installation, the selection of a contractor and maintenance. Once an order is placed, customers can either have purchases delivered or can pick them up at a nearby store location. We strive to use our various sales channels to make our customers transactions easy and efficient.

Experienced Management Team with a Proven Track Record

Our senior management team has extensive experience with publicly traded, high-growth retail companies. We believe our company benefits in particular from the leadership of Tom Sullivan, our founder and the chairman of our board of directors, who is a veteran of the specialty hardwood flooring retail business. Under his guidance, we experienced rapid growth and established ourselves as a leading company in the industry. He continues to have an active role in determining our strategic direction and assisting with our day-to-day operations. We believe that his product knowledge and relationships with our suppliers are important competitive advantages. In addition, Jeff Griffiths, our president and chief executive officer, has more than 30 years of experience in the retail industry. He recently served as the president and chief executive officer of videogames retailer Electronics Boutique from 2001 to 2005. Our

Table of Contents

chief financial officer, Dan Terrell, has more than 15 years of experience working with reporting companies in the retail industry. Over the past two years, we have assembled a management team with extensive experience in the specialty retail and hardline retail industries across a broad range of disciplines, including store operations, marketing, merchandising and information systems, production, distribution and finance. We intend to continue to leverage our management team s experience and acumen to execute our strategy effectively. Upon completion of this offering, our executive officers and directors will own 54% of our company.

Growth Strategy

We intend to continue to increase revenues and profitability by strengthening our position as a leading provider of hardwood flooring within our growing market. Specific elements of our strategy for continued growth include the following:

Expand Our Store Base

The hardwood flooring market is highly fragmented, and we believe there is a significant opportunity to expand our store base. Because of the low capital investment required to open new stores and the attractive returns on investment that our stores generate, we intend to continue to expand our store base. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores during 2007. We believe that we have opportunities to expand our store presence in most of our existing markets, as many of our larger markets have only one or two stores. We also plan to open stores in new markets, leveraging our national advertising campaign, as we believe our store concept has broad national appeal and can be successful in a wide variety of large and small markets.

Improve Existing Store Sales Growth

We seek to drive productivity through strong comparable store sales performance and by improving operational efficiencies. We expect that sales growth will be driven by our investment in our proprietary brands, targeted marketing campaigns and more efficient sales and inventory planning and forecasting. We also expect sales growth will be supported by favorable long-term industry trends, including increasing remodeling activity and consumer preference for hardwood flooring. In addition, we continue to build on what we believe is our strong track record of consistent store-level execution. We intend to maintain our low-cost store model for both our existing and new stores, to focus on increasing gross margins across our assortment of products and to focus on maintaining retail pricing discipline among our stores. We also incentivize our employees using commissions derived from store-level metrics. We plan to increase the number of product shipments from our suppliers directly to our stores, thereby saving delivery time and expense from our Toano facility.

Expand Operating Margins

We attribute our success to our focus on and our ability to deliver on our value proposition to the customer, which results from leveraging our strength as a vertically-integrated, low-cost operator. As we continue to increase our revenues by opening new stores and marketing our proprietary brands, we also plan to decrease marginal costs by taking advantage of improving economies of scale in purchasing, leveraging our existing infrastructure and other fixed expenses, particularly general corporate overhead and lease expenses, and optimizing our finishing, distribution and supply chain management. We believe that we have built out our operations to be able to scale upward to sustain a high level of growth. For example, while we currently operate one finishing line at Toano, which we believe can support our planned growth for at least the next three years, we have the space to construct a second finishing line in the facility that would double our capacity. We believe the second finishing line would require limited incremental investment and could be funded through cash flow from operations. Similarly, we have designed our inventory and management information systems to be scalable as we expand our operations.

Leverage Brand Marketing Across Multiple Channels

We use our advertising and marketing activities and our multiple sales channels particularly our website and our call center to help educate potential customers about hardwood flooring. As customers learn more about hardwood flooring and how best to shop for it, they also learn more about our products and value proposition, which we believe drives customer store visits and purchases of our products. We believe that as we continue to leverage our multi-channel strategy, we will drive repeat customer traffic. We have also made a significant advertising and marketing investment to link our brands, particularly Lumber Liquidators and Bellawood, to quality and value as well as to establish ourselves as the hardwood flooring experts. We believe that opportunities exist to expand sales with marketing initiatives focused within and across each of our sales channels. For example, in February 2007, we conducted our first mass mailing of catalogs, and we have continued expanding our catalog mailing efforts to prospective customers. Based on our focus group research, we believe that more than 90% of our customers visited our website before making a purchase from us. Initiatives like these should enable us to more cost-effectively reach new customers and encourage previous customers to make additional purchases from us. As we continue to grow and open more stores, we believe that our marketing and branding activities will become more efficient and targeted. We also believe that our customer acquisition costs will decline on both a per-customer and per-store basis.

Our Market

The hardwood flooring market represents approximately 10% of the overall U.S. floor coverings market, which includes carpet and area rugs, hardwood and softwood flooring, ceramic floor and wall tile, resilient sheet and floor tile and laminate flooring. In its 2005 Wood Flooring report, as subsequently updated in March, June and September 2007, Catalina Research estimates that the value of U.S. hardwood flooring wholesale sales in 2005 was approximately $2.3 billion (representing retail sales of $4.1 billion), and, in addition, estimated in November 2005 that the market would grow at a compound annual growth rate of 7.4% through 2011. Despite projected long-term growth, however, Catalina Research estimates that U.S. hardwood flooring sales declined 10.6% in 2006 and declined 14.1% in the first half of 2007 compared to the same period in 2006. Similar declines were estimated across most types of flooring, and were due in particular to decreased new housing demand. The majority of our sales, however, are to consumers engaged in remodeling projects, so despite these market declines our net sales increased 36% from 2005 to 2006 and 20% from the first six months of 2006 to the first six months of 2007. Although we anticipate there may be some volatility in the near term due to decreased housing demand, which Catalina s growth estimate may not fully reflect, we believe we will continue to benefit from several key long-term industry trends and characteristics including:

Increased Home Improvement Spending. Based on the U.S. Census Bureau construction report, residential improvement spending grew at a 7.0% compound annual growth rate from 2000 to 2005. According to the Home Improvement Research Institute, spending on home improvement products is forecasted to grow at a 5.2% compound annual growth rate from 2005 to 2010. The home improvement market is driven by several factors, which include the age of the existing housing stock, home ownership levels, average home size and demographic shifts in the population. We believe home improvement spending is currently being driven in particular by persons engaged in home remodeling projects.

Aging Housing Stock. As homes get older, homeowners remodel in order to maintain habitability, marketability and attractiveness of the home. Also, as homes get older, materials such as floor coverings that were used at the time of initial construction wear out and must be replaced or upgraded to compete with new homes. According to the U.S. Census Bureau, the median age of the U.S. housing stock was 33 years in 2005, which compares to 25 years in 1990 despite record new home construction in recent years.

Increasing Home Ownership. Data from the U.S. Census Bureau shows that home ownership rates increased to 69% in 2006 from 65% in 1995. Homeowners are significantly more likely to spend on residential improvements than landlords and renters. According to the Joint Center for Housing Studies of Harvard University, homeowners increased their residential improvement expenditures 10% annually from 2000 to 2005, while owners of rental properties have increased their spending by less than 4% annually over the same period.

Increasing Average Size of Homes. As homes have increased in average size, there is more floor surface to be covered. According to the U.S. Census Bureau, the average new single family home was estimated to be 2,434 square feet in 2005, a 16.2% increase from 2,095 square feet in 1995.

Favorable Demographic Trends. Purchases by households with more discretionary income have driven increased hardwood flooring sales. Households with incomes of $70,000 or more made approximately 49.4% of total hardwood surface flooring purchases in 2003, up from 32.8% in 1997. The population segment represented by this income bracket was one of the most quickly growing over the past decade. Similarly, households headed by people between 35 and 64 years of age represented 69.2% of total hard surface flooring purchases in 2003, up from 63.8% in 1997. This segment s population will continue to grow, as the U.S. Census Bureau projects the 45 to 64 age segment to increase to 26.2% of the population by 2010 (up from 22.1% of the population in 2000). This constitutes the largest population increase of any age group over that period.

Evolution of the Hardwood Flooring Market. Manufacturers today offer a wider range of wood species than they have historically, including exotic woods and bamboo, as well as distressed and handscraped flooring lines that appeal to a wider range of consumers. Additionally, manufacturers have designed hardwood flooring that is increasingly easier and less costly to install, such as prefinished, engineered floors that can be installed without glue. Prefinished hardwood floors have become highly prevalent due to ease of installation, multiple styles and applications for situations that in the past precluded the use of hardwood floors. Unfinished products usually require professional installation, sanding and multiple coats of varnish. According to industry sources, the percentage of prefinished square feet of flooring sold increased from 38% in 1999 to 50% in 2004.

Greater Attractiveness of Hardwood Flooring. Hardwood flooring sales have grown historically, and we expect that they will continue to grow as consumer preferences shift to hardwood flooring and as industry innovations drive growth, such as through a greater range of product offerings that appeal to varied consumer preferences and hardwood flooring that has been designed for easier and less costly installation. According to the 2005 Wood Flooring report, hardwood represented an estimated 10% of the floor covering market in 2005, up from 9% in 2000. We believe that consumers increasingly prefer hardwood flooring for its perceived cosmetic and durability advantages, as well as its ability to contribute to a healthy home because it is relatively easy to clean and traps less dust, dirt and bacteria than some other types of flooring.

Table of Contents

Our Products

We offer a complete assortment of hardwood flooring that includes prefinished premium exotic hardwoods, engineered hardwoods, unfinished hardwoods and laminates. Our product offering is substantially comprised of our proprietary brands, and we plan to offer new proprietary brands in the future. Our hardwood flooring products are generally available in various widths and lengths. They are generally differentiated in terms of quality and price based on the species, grade of the hardwood and quality of finishing as well as the length of the warranty. In total, we offer nearly 350 different flooring product stock-keeping units (SKUs). Brands generally come either prefinished or unfinished. Prefinished floors are finished in a factory under controlled conditions and are ready to be enjoyed immediately after they are installed. Our prefinished products generally have warranties ranging from 10 to 50 years when used in residential settings, and three to five years when used in commercial settings. We check the quality of our prefinished products using a variety of testing methods. Unfinished hardwood flooring is sanded and finished several times after installation, typically by professional flooring contractors. In addition, some brands have specialized features that appeal to particular customer needs. For example, engineered hardwood products are better suited to areas with higher moisture, because they are less affected by changes in humidity. We also offer a broad assortment of flooring enhancements and installation accessories, including moldings, noise-reducing underlay, and adhesives, that complement our assortment of floor offerings.

The graphic below sets forth the percentage of our 2006 net sales that we derived from each product category:

Hardwood

Solid Hardwood. Our proprietary solid hardwood products are milled from one thick piece of wood, which can be sanded and refinished numerous times. We offer flooring products made from more than 25 wood species, including both domestic woods, such as ash, beech, birch, hickory, northern hard maple, northern red oak, pine and American walnut, and exotic woods, such as bloodwood, cherry, cypress, ebony, koa, mesquite, mahogany, rosewood and teak. We offer a 50-year residential warranty, which we believe is the industry s longest, on our premier Bellawood brand (including the Ty Pennington Collection) because the multiple coats of natural stains and urethane-based sealers that we apply to them produce a product with one of the highest scuff resistant finishes in the industry (as measured by the Taber Abrasion Test). In 2006, Bellawood flooring accounted for approximately one-third of our total flooring sales.

60

Table of Contents

Our proprietary solid hardwood flooring offerings are described in the following table:

Brand	Domestic/ Exotic Wood	Prefinished/ Unfinished	Residential Warranty (years)	SKU Count	Other Characteristics
Bellawood	Both	Prefinished	50	153	Our premium brand; easy to install, with a high-abrasion UV-cured aluminum oxide finish
Ty Pennington Collection	Both	Prefinished	50	4	Unique solid hardwood floors selected by Ty Pennington and featuring a Bellawood finish
Builder s Pride by Dura-Wood	Both	Prefinished	25	22	Solid hardwood for the value-conscious consumer
Virginia Mill Works Co. Handscraped Solid	Domestic	Prefinished	25	9	Handscraped and distressed floors that evoke those found in Colonial American homes
Casa de Colour Collection by Dura-Wood	Domestic	Prefinished	25	13	Solid oak and maple, stained to enhance the natural wood tones
Clover Lea Plantation	Domestic	Both	None	12	Solid pine
R. L. Colston & Sons	Both	Unfinished	None	30	Solid pine

Engineered Hardwood. Our proprietary engineered hardwood products are produced by bonding a layer of hardwood to a plywood backing. Like our solid hardwood floors, our engineered hardwood floors are offered in domestic and exotic wood species. All of our engineered hardwood products are prefinished. One brand, Schôn 4 Single Strip Quick Clic, allows for easy-click installation, in which the floors click together and float above the sub-floor instead of being nailed or glued into place. Our proprietary engineered hardwood flooring offerings are described in the following table:

Brand	Domestic/ Exotic Wood	Residential Warranty (years)	SKU Count	Other Characteristics
Schôn Engineered Floors	Both	30	20	Extra-thick solid hardwood wear layer, approved for below-grade installation
Schôn 4 Single Strip Quick Clic	Both	30	3	Floating wood floors featuring single strip boards and easy-click installation
Virginia Mill Works Co. Engineered	Domestic	30	7	Handscraped and distressed floors that evoke those found in Colonial American homes
Timber Top Engineered Wood Floors	Both	15	6	Have a thinner wood top layer; designed for the more value-conscious consumer

61

Table of Contents

Bamboo and Cork. Bamboo and cork are ecologically friendly choices in flooring that have gained in popularity due to their greater renewability, which we believe appeals to environmentally conscious customers. Bamboo is one of the fastest growing plants and has an extensive root system that creates new bamboo shoots without replanting. Cork flooring, which is durable, acoustical and an insulator, is produced by harvesting the outer bark of the cork oak tree, and the same tree can be harvested numerous times. Our proprietary bamboo and cork flooring offerings are described in the following table:

Brand	Easy-Click Installation	Residential Warranty (years)	SKU Count	Other Characteristics
Schôn Engineered Floating Bamboo Floors	Yes	30	4	Features easy-to-install quick-clic installation and an extra-thick wear layer
Morning Star Bamboo Flooring	No	30	8	Our premier bamboo line, made with 4+ year old bamboo to increase hardness
Ty Pennington Collection	No	30	3	Premium quality bamboo floors selected by Ty Pennington
Lisbon Cork Co. Ltd.	Yes	25	5	Made from real cork; durable; comfortable cushioned surface
Supreme Bamboo by Eco-World Flooring Co.	No	15	4	Designed for the more value-conscious consumer

Laminate. Our proprietary laminate flooring is typically constructed with a high-density fiber board core, inserted between a melamine laminate backing and high-quality photographic paper displaying an image of wood and a ceramic finish, abrasion-resistant laminate top. These products are produced and assembled to our specifications by third parties. Some of our laminate flooring brands allow for easy-click installation or V-groove installation, while others offer a pre-glued undersurface, moisture repellent, soundproofing, single-strip format or a handscraped textured finish. Residential warranties range from 10 to 30 years. We offer various brands and 39 SKUs of laminate flooring in 6mm, 7mm, 8mm and 12mm thicknesses.

Moldings, Accessories and Other Products. We offer a wide variety of hardwood flooring accessories. For example, we sell stair treads and moldings that complement our hardwood floor products. We also sell underlays that can be placed between the new floor and the sub-floor, which insulate sound and cushion the floors. In addition, we sell installation supplies (such as adhesive and trowels), floor cleaning supplies and butcher-block kitchen countertops.

Multiple Integrated Sales Channels

We sell our products through four integrated sales channels, consisting of our stores, call center, website and catalog. We believe that our sales strategy enhances customer service because it provides superior convenience and facilitates the customer s purchasing decision. We provide customers with tools to learn about hardwood flooring and the installation process and give them the ability to view our complete assortment of products through each channel. This integrated process produces operational benefits that improve market penetration and returns on capital.

Table of Contents

Our approach is based on our belief that customers prefer to shop for flooring using multiple channels. Since hardwood flooring is an infrequent purchase for many of our customers, we believe that we increase our chances of making a sale if we are the consumer s choice for expert service at each step of their purchasing decision, from initial education about hardwood flooring to guidance on best maintenance practices for their installed flooring. Our national advertising strategy is designed to raise awareness of our brand and to establish Lumber Liquidators as the first destination for customers who are in the early stages of a purchase decision. Our other marketing efforts, our website and our catalog are similarly designed to both sell products and to provide customers with information throughout the purchasing process. Our research indicates that by the time a customer enters one of our stores, he or she has generally researched our offerings on our website or in our catalog and is ready to make a purchase.

Customers can purchase our products in our stores, or through our call center or website, and can either have those purchases delivered directly to their homes or arrange to pick them up at a nearby store location. With the exception of certain high-volume products, we have found that customers typically expect to take delivery of their products approximately one month after placing an order. Customers who do not take immediate delivery must generally leave a deposit of approximately 50% of the retail sales amount, with the balance payable when the products are delivered. The prices available on our website and from our call center are the same as the prices in our stores.

Stores

We have developed a national store presence, with 111 locations in 42 states as of September 30, 2007. Most of our stores are currently located in primary or secondary metropolitan areas, but we have also succeeded in a number of smaller markets. At present, we generally have no more than two stores in each major metropolitan market, and there are many small and medium-sized markets where we have no stores at all. In identifying new markets, we intend to target selected markets that have demographic and other characteristics similar to those where we have been successful and fill in larger markets with additional stores.

In 2006, our stores that had been open for more than twelve months had average per-store sales of $4.2 million, and we have experienced strong comparable store sales in each of the last four years. Our stores are designed to reflect our low-cost approach to doing business, and consist of a large warehouse and a small attached showroom. The average size of our stores is approximately 6,400 square feet, of which approximately 800 square feet is dedicated to the showroom selling area. We seek buildings that are typically located in industrial or commercial areas that have lower rents than traditional retail locations, are accessible from major roadways and have significant visibility to passing traffic. We enter into short leases, generally for terms of five years, to maximize our real estate flexibility. Our store model targets a pre-tax return on invested capital in excess of 140% for stores open more than three years (including all advertising costs). For the twelve months ended June 30, 2007, we did not have an unprofitable store on a four-wall basis in our portfolio (excluding stores open for less than three months).

We have engaged a national broker to assist us with identifying locations for new stores and negotiating with landlords. After the broker has identified a new site, members of our management team visit the site, and it is reviewed for final approval by our real estate committee. Our first priority is to expand into markets in which we currently do not have a store, or where our existing store is more than an hour s drive away from what we believe is a critical mass of potential customers. We also focus on high density markets that we feel can support multiple stores. In the past, the size of our stores has varied depending on our ability to acquire space opportunistically, but we expect that new stores will be between 5,000 and 8,000 square feet, with approximately 800 square feet dedicated to the showroom and the remaining space used as a warehouse.

Table of Contents

The table below highlights certain information regarding our stores open during each of the five years ended December 31, 2006 and the nine months ended September 30, 2007.

	2002	**2003**	**2004**	**2005**	**2006**	**Nine Months Ended September 30, 2007**
Number of stores at beginning of period	23	25	40	57	76	91
New stores	2	15	17	19	16	20
Closed stores(1)					(1)	
Number of stores at end of period	25	40	57	76	91	111

(1) The 2006 closed location represents a laminate flooring-only store established to operate during the remaining lease period of a relocated store.

Consistent with our low-cost focus, the layout of our stores is simple and includes design elements that consumer research suggests influence purchasing decisions. Our store design is intended to be both informative and functional. For example, wall displays in our stores show a selection of one-foot by two-foot displays of our flooring products, while the floors are generally laid with various examples of the hardwood flooring products we carry. Our research shows that customers correlate our simple, functional store designs and locations outside of high-rent retail areas with a belief that they have received good value for the money they have spent on our products.

A typical store that has been open for more than 12 months is staffed by a store manager and two assistant managers. We hire additional staff to the extent required by a store s level of business. The store manager is responsible both for store operations and for overseeing our customers shopping experience. Many of our store managers have previous retail experience with large retailers in the home improvement industry, the retail flooring industry or the flooring installation industry. Store manager compensation consists of a base salary and commissions.

Average store inventory is approximately $365,000 and consists of both in-stock inventory and order-specific inventory. Our in-stock inventory is generally comprised of high-volume merchandise that our customers prefer to have available at the time of purchase. Products in this category include laminates, bamboo and certain accessories. We stock most of our other products at our Toano distribution facility, from which we can deliver products to our customers across the country within a week.

We expanded our store base by 19 stores in 2005 and 16 stores in 2006. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores in 2007. We intend to continue to expand our store base in the future. Since we began operations, we have closed only one location, a laminate flooring-only store established to operate during the remaining lease period of a relocated store. Our average new store across our markets has historically become profitable within three months of beginning operations and returned its initial cash investment within seven months.

Call Center

More than 50 flooring experts cross-trained in sales, customer service and product support staff our call center. In addition to receiving telephone calls, our call center staff has recently been made available to chat online with visitors to our website, respond to e-mails from our customers and engage in telemarketing activities. Customers can contact our call center to place an order to be delivered directly

64

Table of Contents

to their home or picked up at a nearby store, to make an inquiry or to order a catalog. Callers can also order flooring samples for a nominal fee that is credited towards their first purchase. Our call center uses a scalable Internet-based telephone system that allows for rapid movement of our telephone handsets as needed to any available Internet connection. Our call center staff work on a commission basis. Call center sales fulfilled through our Toano distribution facility are credited to the call center, while those picked up at one of our stores are credited to that store. If the sales credited to the various stores were instead credited to our call center, our call center would constitute our largest store by sales volume.

Website

Our website (www.lumberliquidators.com) serves both to educate consumers and to generate sales, whether through a store, our call center or directly via the website itself. Potential customers want information about the products they are considering, and we seek to provide them with what they need to make an informed decision. Visitors to our website can interact with our flooring experts via live chat and can search through a large database of frequently asked questions we call Flooring 101. We also offer product reviews and an extensive before and after gallery from previous customers, as well as detailed product information and how-to videos that explain the installation process. As with our call center, visitors can also order flooring samples. We have included endorsements by Bob Vila and Ty Pennington on the website to add credibility to our message. As part of our effort to distinguish the brand, we also maintain separate websites specifically for Bellawood (www.bellawood.com) and the Ty Pennington collection (www.tyscollection.com), where customers can go to learn more about those product lines and which directs them to our website or our call center if they want to place an order.

Our Lumber Liquidators website was ranked as one of the top 50 retail websites of 2007 by an Internet industry source. Hitwise, a leading online analytics service, consistently ranks our website first relative to our specialty flooring competitors in overall sessions, page views and visit duration, based on their monthly analysis of several of our larger specialty competitors. Hitwise statistics also indicate that traffic is roughly split between men and women, with persons within the ages 25-34 and 35-44 each constituting approximately 25% of website visitors, and more than half of our visitors coming from households with annual incomes greater than $60,000. In 2007, our website averaged more than 650,000 sessions per month through September 30, 2007, with approximately one out of every seven of our website visitors viewing the store locator page. In 2006, we began a concerted effort to collect the names and email addresses of customers who visit our website so as to better serve their needs and to assist us in marketing our products to them. We had collected approximately 500,000 mailable addresses as of September 30, 2007.

Catalog and Other Mailings

Our direct mail strategy focuses on regular contact with our customers and the targeting of prospective purchasers. We distribute our catalog, as well as other direct mailings, to key consumer and commercial segments around specific store locations. Copies of our catalog can also be obtained through our stores, our call center and our website. Our catalog supports in-store, call center and website sales, and approximately 70% of customers who purchased hardwood flooring from us during 2006 had requested a catalog from us. In February 2007, we conducted our first mass mailing of catalogs, in which we mailed approximately 1.5 million catalogs to former customers and others who had provided us with contact information. Response to that program led us to mail 1.5 million postcards in April, 1.5 million catalogs in May and another 1.5 million catalogs in September. In the first nine months of 2007, we also fulfilled 750,000 catalog requests either by handing catalogs out at a store or mailing them directly to the recipient s home. We believe these mailings supported an increase in store traffic and call center volume that led to more sales. We expect to continue expanding our catalog mailing efforts to prospective customers in markets where we have stores.

Table of Contents

Customers

We seek to appeal to customers who desire a high-quality product at an attractive value, and are willing to travel to less convenient locations to get it. We sell our products principally to existing homeowners, who represent about 80% of our customers based on total customers. Historically, these homeowners are in their mid-30 s or older, are well-educated and have been living in their homes for at least several years. Almost 50% of hardwood surface flooring purchases are made by households with incomes of $70,000 or more. We have found that homeowners like various aspects of wood floors, including appearance and durability, ease of installation, renewability of resources and increasingly higher quality of engineered and laminate flooring. The majority of these customers hire a third-party installer to put in their flooring, with the remainder being do-it-yourself installers. Most of our other sales are to contractors, who are primarily small businesses that are either building a small number of new homes or have been hired by an owner to put in a new floor.

Customer Service and Sales Force

We position ourselves as hardwood flooring experts and believe our high level of customer service reflects this positioning. Key elements of our service include providing consumers with useful product information and answering their hardwood flooring questions, ensuring product availability, following through on customer requests and selling high-quality products at an attractive value. Our store associates are familiar with all aspects of our store operations, and along with our call center staff are trained to understand the characteristics and installation method for the broad range of hardwood flooring as well as guiding customers through the purchase process. Many of our staff have relevant industry experience, and we are currently developing a formal standardized training program for all of our store associates. We actively participate in local trade shows and home and garden shows, which we find to be an excellent opportunity to educate consumers about our products and distribute our catalogs and samples. Our website has a large frequently asked questions section, and potential hardwood flooring consumers can obtain live assistance through our online chat feature. Consumers can also access how-to videos and slideshows that provide detailed instructions on how to choose and install hardwood flooring.

While we generally do not provide or arrange flooring installation, nor do we generally recommend or endorse installers or installation companies, as a courtesy to our customers, each of our stores maintains a list of local third-party flooring installers that they may provide to customers. In August 2007, we began to work with a national installation company that will be either our exclusive or recommended installer at a number of stores we plan to open in 2007. Depending on the success of this program, we may expand it to other stores in the future. Even in these limited circumstances, however, choosing an installer remains the sole responsibility of the purchaser or homeowner, and we disclaim any liability for the work performed (or any damage caused) by any installer, including those on any list our stores may provide.

Marketing and Advertising

We believe that our marketing and advertising supports our position as the hardwood flooring experts and as the specialty retailer that offers the broadest high-quality selection at everyday low prices. We have structured our marketing and advertising strategy to correspond with our understanding of the purchase cycle associated with hardwood flooring. Based on our market research, we believe that prospective customers generally do not buy on impulse. Instead, they invest time prior to their purchase to learn about hardwood flooring generally and to identify the correct hardwood flooring for their home. Accordingly, our marketing strategy emphasizes product credibility, brand awareness, customer education and direct selling.

Table of Contents

We believe that we establish product credibility primarily through the strength of our product and the attractiveness of our pricing. We believe that we have achieved a reputation for quality and low prices, and that our proprietary brands are recognized for excellence by our customers. Our objective is to sell high-quality products at an attractive value, and we offer a large selection of hardwood flooring year-round at everyday low prices, ranging in quality from our premium Bellawood brand to our more economical brands. We try to avoid being perceived as a volume-driven discounter, so while our promotional cycle focuses on particular buying cycles, we generally try to hold our sales around events where we can create some excitement among customers. For example, we hold sales when we acquire bulk amounts of inexpensive inventory where we can pass along the savings, during three-day weekends when a customer has more time to consider (and possibly even install) a new flooring purchase, and during our annual odd lot sidewalk sale in April. In addition, as part of our efforts to optimize inventory levels, we implemented additional price discounts with respect to slower-moving inventory, primarily during the fourth quarter of 2006.

Our product credibility also benefits from celebrity endorsements and product placement opportunities, and we have long-term endorsement arrangements with respected and well-known home improvement celebrities Bob Vila and Ty Pennington. Bob Vila in particular has been associated specifically with our premium Bellawood proprietary brand for several years. Ty Pennington has endorsed both the Lumber Liquidators and Bellawood brands and has his own hardwood flooring collection, the Ty Pennington Collection. We also co-sponsor various television shows such as Extreme Makeover: Home Edition and HGTV s Dream Home, which use our products and enable potential customers to see both what our flooring will look like after installation and the relative ease with which it can be installed.

We increase brand awareness in a variety of ways, including both advertising and by demonstrating to customers our unique value proposition. We believe that our Lumber Liquidators brand is positioned based on three primary attributes selection, price and service while our Bellawood brand is known as a premium flooring brand within the industry. Over the last few years, we have invested significantly to build awareness and demand for all of our proprietary brands. To increase brand awareness, we conduct ad campaigns on both a national and local level using both traditional and new media. Our activities include:

- buying ads in national and local publications, such as home and garden magazines and local newspapers;
- using targeted television advertising on cable networks such as HGTV, TLC, DIY Network and A&E Network, co-sponsoring television shows like This Old House and securing product placement on television shows like those noted above;
- advertising on syndicated radio programs such as The Rush Limbaugh Show and various programs on National Public Radio;
- engaging in sports marketing by sponsoring the truck driven by Todd Bodine (the 2006 NASCAR Craftsmen Truck Series champion) and engaging in marketing opportunities with Major League Baseball and the National Basketball Association;
- engaging in banner advertising on the Internet, sponsoring links on well-known search engines, having storefronts with large e-tailers and having a large network of online affiliate partners; and
- supporting charitable causes and local communities, including support for Habitat for Humanity, Tomorrow s Children Fund, the National Braille Press and Homes For Our

Troops.

We believe our national advertising campaigns have been successful, and we expect to see greater returns on our investment in national advertising as more stores open near people who have already been

67

Table of Contents

introduced to our brands. We expect to place a greater focus on local advertising to support targeted store growth while maintaining appropriate levels of national advertising. We believe that the percentage of our revenues devoted to marketing and advertising will decline as we continue to expand.

We strive to educate the customer in a variety of ways, including through our website, our catalog and our employees (both in the store and at external events, like trade shows). We also use a variety of mechanisms that directly support sales and focus on identifying new prospective customers and contacting known prospective customers to encourage them to make a purchase. Many of these require the potential customer to opt in, which we believe increases our response rate. For example, we send emails to our past customers and self-identified prospective customers, and we employ opt-in sweepstakes with major brands such as HGTV and TLC. We also distribute our catalog and other direct mailings throughout the year to key consumer and commercial segments targeted around specific store locations, and engage in telemarketing campaigns.

Suppliers

We work directly with a select group of vendors and mills with whom we have cultivated long-standing relationships to ensure a consistent supply of high-quality product at the lowest prices. As part of ensuring the high-quality nature of our brands, we have developed demanding product standards. As we have grown, we believe our supplier relationships have strengthened, which we believe helps to ensure our access to a broad selection of products. Many suppliers have grown to support our business. We select suppliers based on a variety of factors, including their ability to supply products that meet industry grading standards and our specifications. As part of ensuring that they are meeting relevant standards, we inspect samples, make periodic site visits to our suppliers mills and selectively inspect inbound shipments at our distribution center. Based on our historical experience, we believe that some of the mills that we use are among the best in their respective markets. We also support social and environmental responsibility among our supplier community, and the majority of our suppliers have entered into an environmental and social responsibility agreement with us. This agreement contains a code of conduct regarding our expectations concerning environmental, labor and health and safety matters. We encourage the use of renewable resources, and generally prefer to use suppliers that operate in areas where the harvest rate is slower than tree planting and growth rates.

We currently purchase products from approximately 90 vendors. We primarily purchase flooring directly from mills and trading companies. In 2006, 68% of our hardwood merchandise was purchased directly from mills, 31% was purchased from trading companies and 1% of our product was purchased through buying agents. Trading companies contract with mills to make products for us, and handle certain shipping and customs matters. In 2006, one of our suppliers, Sequoia Floorings, accounted for approximately 14% of our purchases, and acted as agent for another of our suppliers that accounted for another 7% of our purchases. Including those companies, our top 10 suppliers account for approximately 63% of our supply purchases in 2006. We believe that we are one of the largest customers for most of our largest suppliers, which we believe enables us to obtain better prices in some circumstances.

We do not have long-term contracts with most of our suppliers, as we believe is standard in our industry, but we believe we have stable long-term historical relationships with the majority of mills with whom we do business. We generally purchase product on an order-by-order basis, and write orders for delivery in 90 to 180 days. We also have one long-term purchase agreement with a trading and import company that we entered into in July 2006. Pursuant to the terms of that agreement, we are required to order a specified minimum amount of product each year, totaling approximately 27 million square feet of product (representing less than 5% of our estimated purchasing needs) over the four-year period of the agreement. The agreement provides for a set menu of products, including prices and specifications, from which we can pick in placing our orders. The agreement also provides for a detailed process by which either party can request a change in prices or specifications, or add or delete products from the menu.

Table of Contents

Overseas suppliers deliver our product to us by sea, usually requiring between 21 and 35 days from port to port. These products are delivered to a U.S. port of entry, most frequently Norfolk, Virginia, after which the majority is shipped to our Toano distribution facility for finishing (when required) and distribution to our stores. The balance is shipped directly from the port of entry to our stores. Products supplied by our North American suppliers are generally delivered to our Toano facility or our stores by truck. Our Toano facility is strategically located near the international shipping port in Norfolk, Virginia and major east-west and north-south interstate highways. In 2006, approximately 30% of our product was sourced from Asia, approximately 24% was sourced from South America, approximately 35% was sourced from North America and 11% was sourced from other locations. All of our foreign purchases are negotiated and paid for in U.S. dollars.

Although we maintain strong relationships with our suppliers, we believe that opportunities exist to improve purchasing terms in the future. In evaluating suppliers, one of the factors we consider is their access to new or hard-to-find species of wood, so that we can continue to expand our range of exotic hardwood products. We also seek out new mills that can meet our standards, and we work with them to evaluate new hardwood species and new technologies that may allow us to expand or improve our operations. We continually seek out new suppliers to ensure that we have sufficient product flow to support our current operations and expected growth. We believe that alternative and competitive suppliers are available for most of our products.

Finishing

We finish more than 20 million square feet of prefinished hardwood flooring annually at our state-of-the-art finishing facility in Toano. This includes approximately 70% of all Bellawood products, the balance of which we obtain from qualified prefinishing suppliers in both North and South America. We also finish small quantities of certain of our other products at that facility. The Toano finishing facility sources both domestic and exotic unfinished flooring from more than 20 mills, trading companies and buying agents located in North and South America, Asia and Australia. We currently operate one finishing line at Toano and we have the space to construct a second finishing line in that facility. We continually invest in improving our process controls and product quality, and we believe that our existing finishing infrastructure at our Toano facility can support our planned growth over at least the next three years. We believe the incremental investment to fund a second finishing line at our Toano facility will be limited and can be funded through cash flow from operations.

At our Toano facility, we prefinish the hardwood flooring to produce a product that has one of the highest scuff resistant finishes in the industry as measured by the Taber Abrasion Test, an abrasion testing method designed to measure the abrasion resistance of protective floor finishes. The prefinishing process involves several steps. We begin the process by sanding the unfinished hardwood to ensure that it has uniform thickness and optimal smoothness. We then apply multiple coats of natural stains and urethane-based sealers to enhance grain appearance and provide excellent abrasion resistance and toughness. Each coat is cured to ensure proper adhesiveness to the hardwood, and the wood is scuffed with denibber brushes between coats to ensure smoothness. Finally, we apply a topcoat, which provides scratch and stain resistance, further enhances abrasion resistance and controls the final gloss or sheen of the hardwood flooring. The topcoat is then cured and cooled, and the prefinished hardwood is graded and boxed.

We have adopted sophisticated quality assurance policies and techniques, which are based on national and international standards where appropriate. These standards specify requirements for flooring products, sampling techniques and other quality-related activities, and are published by organizations such as the National Wood Flooring Association, the National Oak Flooring Manufacturers Association and the International Organization for Standardization.

Table of Contents

Throughout the prefinishing process, we perform numerous tests and visual inspections to verify that the flooring complies to our specifications, that we are maintaining effective control over the finishing process and that the final prefinished hardwood flooring meets our requirements. In developing these policies and techniques, we emphasize defect prevention, minimizing variations in our products, decreased waste and workplace safety. For example, samples of each of our products undergo Taber Abrasion Testing. As part of the testing process, flooring is secured to a turntable that is a weighted wheel covered in sandpaper. The turntable is rotated, causing the sandpaper to wear against the finish. Each full revolution is counted as a Taber cycle, and the number of rotations that it takes the sand paper to get through the finish becomes the Taber rating for that finish.

Distribution, Order Fulfillment and Inventory Management

We operate a single distribution center located in Toano, Virginia. We warehouse our products at that facility before shipping them to our stores by truck, and approximately 85% of our merchandise passes through this facility before we move it to our stores. It generally takes between two to five days for a shipment to reach our stores, and each store receives an average of 1.4 shipments per week. In some cases, our suppliers deliver products directly to our stores. We believe that our existing distribution infrastructure at our Toano facility can support our planned growth over at least the next three years. We continually monitor our operations to identify opportunities to improve efficiencies, and are currently working with a consultant to improve the efficiency of our operations and plan for future growth.

In the first quarter of 2007, we upgraded our corporate network with high-speed dedicated lines capable of carrying both voice and data communications. At this time all of our stores were rewired for voice and data. Voice communications are now carried over a scalable Internet-based network. Before the end of 2007, we plan to implement a new point-of-sale system in all of our stores. This touch screen system provides for real-time tracking of inventory and sales information. We believe that our updated inventory management and communications systems will allow for improved forecasting, more efficient inventory management, rapid stock replenishment and concise merchandise planning. We believe that these systems will give us substantial flexibility as we grow.

Competition

We are the leading store-based national hardwood flooring specialty retailer, and compete in a hardwood flooring market that is highly fragmented. We compete on the basis of price, quality, selection and availability of hardwood flooring we offer our customers, as well as the level of customer service we can provide. Our competitive position is also influenced by the availability, quality and cost of merchandise, labor costs, finishing, distribution and sales efficiencies and our productivity compared to that of our competitors. The market includes both national and regional home improvement chains which specialize in the lower-end, higher-volume flooring market and offer a wide range of home improvement products other than flooring. We also compete against smaller national specialty flooring chains, some of which have an Internet presence, and a large number of local and regional independent flooring retailers, including a large number of privately-owned single-site enterprises.

We estimate, based on internal market research, that our share of the hardwood flooring retail market was approximately 5% in 2006, up from approximately 4% in 2005. We believe that we compete effectively against the large national chains by offering competitive prices, higher-quality hardwood flooring products, a broader product assortment, a shorter delivery time, and better customer service by virtue of our more knowledgeable sales staff and single-product focus. In addition, we believe that our largest competitors with Internet operations focus to a greater extent on the lower-priced segment of the hardwood flooring market, particularly engineered, bamboo and laminate flooring. The remainder of the hardwood flooring market is dominated by small local independent retailers that usually sell carpet and

Table of Contents

tile in addition to hardwood flooring. Most of these retailers purchase their hardwood flooring from domestic manufacturers or distributors, and typically do not stock hardwood flooring, but order it only when the customer makes a purchase. As a result, we believe it takes these retailers longer than us to deliver their product to customers, and their prices tend to be higher than ours.

We also compete against companies that sell other types of floor coverings, such as carpet, vinyl sheet and tile, ceramic tile, natural stone and others.

Employees

As of December 31, 2006, we had 490 employees, 96% of whom were full-time and none of whom was represented by a union. Of these employees, 57% work in our stores, 22% work in corporate or similar functions (including our call center employees) and 21% work in our finishing and distribution operations. As of September 30, 2007, we had 651 employees, of whom 64% work in our stores, 17% work in corporate or similar functions and 19% work in our finishing and distribution operations. We believe that we have good relations with our employees.

Properties

As of September 30, 2007, we operated 111 stores located in 42 states. Our stores average approximately 6,400 square feet, of which an average of 800 square feet is dedicated to the showroom and the remainder used as a warehouse. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores (which, since they are not yet operational, are not included in the table below) in 2007. Our Toano, Virginia finishing and distribution facility has 307,784 square feet, of which approximately 32,000 square feet are office space, and is located in on a 74-acre plot. We currently operate one finishing line at Toano, and we have the space to construct a second finishing line in that facility.

The table below sets forth the locations (alphabetically by state) of our stores in operation as of September 30, 2007.

State	Stores	State	Stores	State	Stores	State	Stores
Alabama	1	Indiana	2	Missouri	1	Oregon	1
Arizona	2	Iowa	1	Nebraska	1	Pennsylvania	4
Arkansas	1	Kansas	1	Nevada	2	S. Carolina	2
California	9	Kentucky	1	New Hampshire	2	Tennessee	3
Colorado	2	Louisiana	2	New Jersey	3	Texas	9
Connecticut	2	Maine	1	New Mexico	1	Utah	1
Delaware	1	Maryland	2	New York	6	Virginia	6
Florida	11	Massachusetts	4	N. Carolina	2	Washington	3
Georgia	2	Michigan	3	Ohio	4	W. Virginia	1
Idaho	1	Minnesota	2	Oklahoma	2	Wisconsin	3
Illinois	2	Mississippi	1				

We lease all of our stores and our Toano finishing and distribution facility. Our store leases generally have an initial operating lease term of five years and most provide options to renew for specified periods of time. A majority of our leases provide for fixed monthly or annual rentals. Certain of our leases include provisions for escalating rent, generally at fixed increases on predetermined dates. Many of our leases require us to pay taxes, insurance and common area maintenance expenses associated with the properties. The initial operating lease term for our Toano facility runs through December 31, 2019, with an option to renew for an additional 15-year term. Our Toano lease provides

Table of Contents

for fixed monthly rent with an annual increase of 3.0%, and it requires that we pay real estate taxes associated with the property, carry certain insurance and maintain the property in good condition and repair.

We currently lease 24 of our store locations and our Toano facility, which includes a store location, from ANO LLC, a company that is wholly owned by Tom Sullivan, our founder and the chairman of our board of directors. Tom is also the sole owner of DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and has a 50% membership interest in BMT Holdings, LLC, and we lease one store location from each of these entities. See Certain Relationships and Related Party Transactions.

Intellectual Property and Trademarks

We have a number of marks registered in the United States, including Lumber Liquidators®, Bellawood®, 1-800-FLOORING®, Dura-Wood®, Blutec®, Quickclic®, Virginia Mill Works Co. Hand Scraped and Distressed Floors®, Morning Star Bamboo Flooring® and Dream Home Laminate Floors® and the Lumber Liquidators design mark, and have applied to register a number of other trademarks, including Builder s Pride , Schôn Engineered Floors and other product line names. We have also registered certain marks in jurisdictions outside the United States, including the European Union, Canada, Australia and Japan, and have registration applications pending in several other jurisdictions. We regard our intellectual property as having significant value and these names are an important factor in the marketing of our brands. We are not aware of any facts that could be expected to have a material adverse effect on our intellectual property.

Government Regulation

We are subject to extensive and varied federal, state and local government regulation, including regulations relating to employment, public health and safety, zoning and fire codes. We operate each of our stores and finishing facility and distribution center in accordance with standards and procedures designed to comply with applicable codes and regulations.

Our operations and properties are also subject to federal, state and local laws and regulations relating to the use, storage, handling, generation, transportation, treatment, emission, release, discharge and disposal of hazardous materials, substances and wastes and relating to the investigation and clean up of contaminated properties, including off-site disposal locations. We do not incur significant costs complying with environmental laws and regulations. However, we could be subject to material environmental costs, liabilities or claims in the future, especially in the event of changes in existing laws and regulations or in their interpretation.

Our suppliers are also subject to the laws and regulations of their home countries, including in particular laws regulating forestry and the environment. We consult with our suppliers as appropriate to ensure that they are in compliance with applicable home country laws. We also support social and environmental responsibility among our supplier community, and the majority of our major suppliers have entered into an environmental and social responsibility agreement with us. This agreement contains a code of conduct regarding our expectations concerning environmental, labor and health and safety matters, which includes among its guidelines an understanding that our suppliers must comply with the laws, rules and regulations of the countries in which they operate.

Table of Contents

Legal Proceedings

We are involved in a claim brought by Dr. Clifford Wayne Bassett in the U.S. District Court for the Southern District of New York against us, E.W. Scripps Company (Scripps) and others, in connection with an article we purchased from Scripps, describing the benefits of hardwood flooring in relation to other types of flooring. The article contained a quote by Dr. Bassett, an allergist, who claims the quote was unauthorized. Dr. Bassett has asserted damages in excess of $10 million. The matter is in the early stages of litigation and, while there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss to us, if any, at this time. We intend to defend vigorously against this claim and, to the extent warranted, to seek contribution or indemnification from other parties.

In July 2007, a former senior executive officer filed a demand for arbitration in connection with his resignation of employment in May 2006. That executive alleges that he terminated his employment for good reason, as defined in his employment agreement and our warrant plan, based on an allegedly substantial reduction in his responsibilities. In his demand for arbitration, the former senior executive contends that we breached our obligations to him upon his resignation of employment. He is seeking damages of approximately $0.7 million (plus the value of certain other specified benefits), as well as a declaration that he has owned 1% of the company since he terminated his employment. An arbitration hearing was held on October 1-2, 2007. The parties will be afforded the opportunity to submit post-arbitration briefs and additional testimony and evidence may be presented. While there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss to us, if any, at this time. We intend to defend vigorously against this claim.

In addition, we are involved in various claims and legal actions in the ordinary course of business. We do not believe that the ultimate resolution of these actions will have a material adverse effect on our financial position, results of operations, liquidity or capital resources. However, a significant increase in the number of these claims or an increase in amounts owing under successful claims could materially and adversely affect our business, financial condition, results of operations and cash flows.

Table of Contents

MANAGEMENT

Executive Officers and Directors

The following table sets forth information about our executive officers and directors, including their ages as of September 30, 2007.

Name	Age	Position
Thomas D. Sullivan	48	Chairman of the board of directors; Founder (1)
Jeffrey W. Griffiths.	56	President and chief executive officer; Director (2)
Douglas T. Moore	51	Director (1)
John M. Presley	47	Director (1)
Martin F. Roper	44	Director (1)
Richard D. Tadler	50	Director (1)
Macon F. Brock, Jr.	65	Director nominee (3)
Daniel E. Terrell	43	Chief financial officer
E. Livingston B. Haskell	35	Secretary; General corporate counsel
Rick A. Boucher	50	Senior vice president, supply chain
Robert M. Morrison	51	Senior vice president, store operations
Marco Q. Pescara	42	Senior vice president, direct marketing and advertising
Andrew P. Shulklapper	45	Senior vice president, merchandising
Kenneth M. Strohschein	36	Senior vice president, information technology
H. Franklin Marcus, Jr.	62	Vice president, finance; Treasurer
Tyler C. Greenan	38	Vice president, store operations

(1) The parties to the stockholders agreement described below under Certain Relationships and Related Party Transactions agreed to elect to our board one individual nominated by TA Associates Funds, two individuals nominated by Mr. Sullivan and two individuals nominated by Mr. Sullivan who are deemed acceptable by TA Associates Funds. TA Associates Funds selected Mr. Tadler and Mr. Sullivan selected himself among the initial nominees. Messrs. Moore, Presley and Roper were subsequently nominated and elected to the board effective April 2006.

(2) Mr. Griffiths serves on our board pursuant to his employment agreement with us.

(3) Mr. Brock has been nominated to serve on the board, effective the day after this offering closes.

Thomas D. Sullivan is our founder and has been the chairman of our board of directors since our inception in 1994. Prior to September 2006, Mr. Sullivan also served as president and chief executive officer since our incorporation in 1994. Mr. Sullivan serves on the board of directors of Dilon Technologies, LLC and several other privately held companies.

Jeffrey W. Griffiths has been the president and chief executive officer of Lumber Liquidators since September 2006, and a director of Lumber Liquidators since October 2006. Mr. Griffiths was previously the president and chief executive officer of video game retailer Electronics Boutique Holdings Corp. (EB) from 2001 through 2005, when EB merged with GameStop Corp. Mr. Griffiths career at EB spanned more than 20 years. He served as vice president and senior vice president of merchandising, marketing and distribution for EB from 1987 to 1996 and from 1996 to 2001, respectively. Mr. Griffiths also served as a director of EB from 2001 to 2005 and of Game PLC, formerly Electronics Boutique PLC, from 1995 to 1997. Mr. Griffiths holds a B.A. in history from Albright College and an M.B.A. from Temple University. He serves on the boards of directors of THQ, Inc., on the board of trustees of Albright College and the board of directors of the Philadelphia Academies Inc.

Douglas T. Moore has been a director of Lumber Liquidators since April 2006. Mr. Moore currently serves as senior vice president, hardlines merchandising for Sears Holdings Corporation in Hoffman

74

Table of Contents

Estates, Illinois. In this capacity he is the chief merchant for the appliance, lawn and garden, tools and home electronics businesses for Sears and KMart. Mr. Moore served for 17 years as a senior executive of Circuit City Stores, Inc., with his last position as executive vice president, chief merchandising officer. Mr. Moore has also held operational and consumer marketing positions at AMF Bowling, Inc., A.H. Robins Company, Inc. and the Carnation Company. He received his undergraduate degree and M.B.A. from the University of Virginia.

John M. Presley has been a director of Lumber Liquidators since April 2006. In May 2006, Mr. Presley joined Fifth Third Bancorp in a strategic initiative post, where he is responsible for executing market banking strategies in existing and emerging markets. He previously served as chief financial officer for Marshall & Ilsley Corp. from 2004 to 2006, and was chief financial officer of National Commerce Financial Corp. in Memphis, Tennessee, and president and chief executive officer of First Market Bank in Richmond, Virginia. Mr. Presley holds a B.A. in economics and business administration from Rhodes College.

Martin F. Roper has been a director of Lumber Liquidators since April 2006. Mr. Roper is the president and chief executive officer of The Boston Beer Company, Inc., where he has worked since 1994 and has been a director since 1999. Prior to assuming that position in January 2001, he had served as the president and chief operating officer of that company since December 1999. Mr. Roper holds a B.A. in engineering and M.A. in engineering in manufacturing technology from Cambridge University and an M.B.A. from Harvard Business School. He serves on the board of directors of The Boston Beer Company, Inc.

Richard D. Tadler has been a director of Lumber Liquidators since December 2004. Mr. Tadler is a managing director of TA Associates, Inc. He has been associated with TA Associates, Inc. since 1987, specializing in medical and specialty service businesses. Mr. Tadler holds a B.S. in finance from the McIntire School of Commerce at the University of Virginia and an M.B.A. from the Wharton School of Finance. He is currently a director of several privately held companies and non-profit organizations.

Daniel E. Terrell has been the chief financial officer of Lumber Liquidators since October 2006. Prior to assuming this position, Mr. Terrell served as our controller from November 2004. Mr. Terrell was previously the vice president, controller & credit of Peebles Inc., a specialty apparel retailer that he joined in 1990 and where he continued to work after it was acquired in 2003 by Stage Stores, Inc. Before joining Peebles, Mr. Terrell worked for Ernst & Young. Mr. Terrell holds a B.S. in accounting from Virginia Tech.

E. Livingston B. Haskell has been the secretary and general corporate counsel of Lumber Liquidators since July 2006. Prior to assuming this position, Mr. Haskell was a partner at Williams Mullen and, before February 2006, was an associate at that firm. Mr. Haskell holds a B.S. in finance and marketing from the McIntire School of Commerce at the University of Virginia and a J.D. from Washington and Lee University.

Rick A. Boucher has been senior vice president, supply chain of Lumber Liquidators since July 2007. Prior to assuming this position, Mr. Boucher served more than 22 years with Cadbury Schweppes PLC as the North American vice president of logistics and distribution. Mr. Boucher holds a B.D. in business administration from Niagara College.

Robert M. Morrison has been the senior vice president, store operations of Lumber Liquidators since January 2006. Prior to assuming this position, Mr. Morrison worked at and was part-owner of Morrison/Fleming Solutions from May 2005. Mr. Morrison was also president of Artistic Tile, Inc. from 2004 to 2005 and senior vice president and chief operating officer of Waterworks Inc. from 1999 to 2004. Mr. Morrison holds a B.S. in geology from Michigan State University.

Table of Contents

Marco Q. Pescara has been the senior vice president, direct marketing and advertising of Lumber Liquidators since April 2006. Prior to assuming this position, Mr. Pescara served for more than five years as the vice president of direct response and marketing integration at Hickory Farms, Inc. Mr. Pescara holds a B.S. from the University of Toledo, an M.S. from Boston University and an M.B.A. from the University of Pittsburgh.

Andrew P. Shulklapper has been the senior vice president, merchandising of Lumber Liquidators since February 2007. Prior to assuming this position, Mr. Shulklapper was the division merchandise manager, consumer electronics for Sears Holdings Corporation from 2004 until 2007 and vice president, global market research for Displaysearch from 2003 to 2004. He also worked at Circuit City Stores, Inc. for twelve years, and the last position he held there was division merchandise manager for consumer electronics. Mr. Shulklapper holds a B.A. in economics from the University of Vermont.

Kenneth M. Strohschein has been the senior vice president, information technology of Lumber Liquidators since February 2006. Prior to assuming this position, Mr. Strohschein worked for Hickory Farms, Inc. from 2003, where he served as vice president of management information systems, chief information officer of that company from 2004 to 2006. Mr. Strohschein also worked for ten years at Busch s Incorporated, a supermarket chain where, among other positions, he served as director of information technology for eight years. Mr. Strohschein holds a B.S. in management information systems from Kennedy-Western University.

H. Franklin Marcus, Jr. has been the vice president, finance and treasurer of Lumber Liquidators since October 2006. Prior to assuming this position, Mr. Marcus served as our chief financial officer from 2001 to 2006 and our secretary from 2004 to 2006. Mr. Marcus holds a B.S. in accounting from the McIntire School of Commerce at the University of Virginia.

Tyler C. Greenan has been the vice president, store operations of Lumber Liquidators since 2003. Prior to assuming this position, Mr. Greenan served as a regional manager and our vice president of store operations from 1998. Mr. Greenan holds a B.A. from the University of Miami.

Set forth below is a brief description of Mr. Macon F. Brock, Jr., who we expect will become a director effective the day after this offering closes:

Macon F. Brock, Jr. has been nominated to serve as a director, effective the day after this offering closes. Mr. Brock is a founder of Dollar Tree Stores, Inc. He served as the President of Dollar Tree from 1986 until 2001 and as Chief Executive Officer from 1993 until 2003. He has been a director of Dollar Tree since 1986 and Chairman of the Board since 2001. Until 1991, Mr. Brock was an officer and director of K&K Toys, Inc. Mr. Brock is Chairman of Randolph-Macon College. Mr. Brock also serves on the boards of directors of several smaller privately held companies and non-profit organizations. Mr. Brock earned his B.A. from Randolph-Macon College and served as a Captain in the U.S. Marine Corps. He was a special agent for U.S. Naval Intelligence before entering the retail business.

Table of Contents

Board of Directors

Board Structure

We currently have six directors. We have nominated Macon Brock to serve on the board, effective the day after this offering closes. All members of the board are elected annually. In connection with this offering, we will change the structure of the board and the method of electing directors. The board will be divided into three classes, as nearly equal in number as possible, serving staggered terms. About one-third of the board will be elected annually. See Description of Capital Stock Certain Certificate of Incorporation and Bylaw Provisions. Our board has determined all of our directors other than Messrs. Sullivan, Griffiths and Tadler (for purposes of the audit committee only) meet the independence requirements of the New York Stock Exchange and the federal securities laws.

Board Committees

Prior to this offering, our board of directors will establish standing committees in connection with the discharge of its responsibilities. These committees will include an audit committee, a compensation committee and a nominating and governance committee. The board of directors will also establish such other committees as it deems appropriate, in accordance with applicable law and regulations and our certificate of incorporation and bylaws.

Audit Committee. Prior to this offering, our board of directors will establish an audit committee, which is expected to consist of Messrs. Presley (chair), Moore and Roper, to assist our board in overseeing the preparation of our financial statements, the independent registered public accounting firm s qualifications and independence, the performance of our internal audit function and independent registered public accounting firm and our compliance with legal and regulatory requirements. Within a year of this offering, all of the members of the audit committee will be independent, as determined in accordance with the rules of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules.

Compensation Committee. Prior to this offering, our board of directors will establish a compensation committee, which is expected to consist of Messrs. Roper (chair), Tadler and Brock. Within a year of this offering, all of the members of the compensation committee will be independent, as determined in accordance with the terms of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules. The compensation committee will have overall responsibility for evaluating and approving our executive officer incentive compensation, benefit, severance, equity-based or other compensation plans, policies and programs. The compensation committee will also produce an annual report on executive compensation for inclusion in our proxy statement.

Nominating and Governance Committee. Prior to this offering, our board of directors will establish a nominating and governance committee, which is expected to consist of Messrs. Moore (chair), Presley and Brock. Within a year of this offering, all of the members of the nominating and governance committee will be independent, as determined in accordance with the rules of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules. The nominating and governance committee will assist our board of directors in implementing sound corporate governance principles and practices. Our nominating and governance committee will identify individuals qualified to become board members and recommend to our board of directors the director nominees for the next annual meeting of shareholders. It will also review the

Table of Contents

qualifications and independence of the members of our board of directors and its various committees on a regular basis and make any recommendations the committee members may deem appropriate from time to time concerning any recommended changes in the composition of our board.

Limitation of Liability and Indemnification

Our certificate of incorporation and bylaws will limit the liability of directors to the maximum extent permitted by Delaware law. Specifically, a director will not be personally liable for monetary damages for breach of fiduciary duty as a director, except liability for:

- any breach of the director s duty of loyalty to us or our shareholders;
- acts of omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- unlawful payments of dividends or unlawful stock repurchases or redemptions; or
- any transaction from which the director derived an improper personal benefit.

Our bylaws will provide that we will indemnify our directors and officers and may indemnify our employees and other agents to the fullest extent permitted by law. We believe that indemnification under our bylaws will cover at least negligence and gross negligence on the part of indemnified parties. Our bylaws will also provide that we will advance expenses incurred by a director or officer in advance of the final disposition of any action or proceeding, and we may advance expenses incurred by our employees or other agents in advance of the final disposition of any action or proceeding. Our bylaws will also permit us to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in his or her capacity as an officer, director, employee or other agent. We have in the past and may in the future enter into agreements to indemnify our directors, executive officers and other employees as determined by the board of directors. These agreements will provide for the indemnification of directors and officers to the fullest extent permitted by Delaware law, whether or not expressly provided for in our bylaws, and govern the process by which claims for indemnification are considered. We believe that these bylaw provisions and indemnification agreements are necessary to attract and retain the services of highly qualified persons as directors and officers.

The limited liability and indemnification provisions in our certificate of incorporation, bylaws and indemnification agreements may discourage shareholders from bringing a lawsuit against our directors for breach of their fiduciary duty and may reduce the likelihood of derivative litigation against our directors and officers, even though a derivative action, if successful, might otherwise benefit us and our shareholders. A shareholder s investment in us may be adversely affected to the extent we pay the costs of settlement or damage awards against our directors and officers under these indemnification provisions.

There is no pending litigation or proceeding involving any director, officer or employee where indemnification is sought, nor are we aware of any threatened litigation that may result in indemnification claims.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted for directors, officers and controlling persons of us under the foregoing provisions or otherwise, we have been informed that, in the opinion of the SEC, such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

Table of Contents

Compensation Committee Interlocks and Insider Participation

None of the members of our compensation committee, once it is formed, will be or have ever been an officer or employee of us. None of our executive officers serves or has served as a member of the board of directors, compensation committee or other board committee performing equivalent functions of any entity that has one or more executive officers serving as one of our directors or on our compensation committee.

Director Compensation

For 2006, directors who are also our employees, as well as Mr. Tadler, did not receive compensation for their service on our board of directors or any board committee. Each of our other non-employee directors received an annual retainer fee of $15,000, payable quarterly in increments of $3,750, beginning in the quarter in which they were elected. The three non-employee directors who received such compensation (Martin Roper, Douglas Moore and John Presley) were elected effective April 26, 2006, so each received an annual retainer fee of $11,250. This retainer fee covers annual services, including participation in up to six board meetings. If Messrs. Roper, Moore and Presley attended more than six meetings during the year, they would have been entitled to receive meeting fees of $2,500 per meeting attended in person or $1,000 per meeting attended by telephone. Each of Messrs. Roper, Moore and Presley also received options to purchase 26,385 shares of our stock at an exercise price of $7.58 per share (which, based upon a third party valuation of our stock, was the fair market value of a share of our stock on the date the options were granted). Directors have also been reimbursed for expenses incurred in connection with their service as directors, including travel expenses for meeting attendance.

Upon consummation of this offering, directors who are also our employees will continue to receive no compensation for their service on our board of directors or any board committee. We expect to pay all of our non-employee directors annual retainer fees and additional fees for attendance at board meetings in excess of six per year, and making annual option grants to our non-employee directors under our 2007 Plan, in each case in the amounts set annually by the board of directors. While the final amounts have not yet been determined by the board, we currently expect that each non-employee director will receive an annual cash retainer of $25,000 and an annual grant of restricted stock units with a one-year vesting period, in an amount to be set based upon the closing price of our common stock at the end of the day on which we hold our annual shareholder s meeting, but not to exceed a value of approximately $65,000. We expect that directors will be given the opportunity to take the cash portion of their retainer in company stock. Annual retainers are expected to be paid to the chairperson of each committee of the board of directors as follows: $15,000 for the audit committee chairperson, $7,500 for the compensation committee chairperson and $5,000 for the nominating/governance committee chairperson. Annual retainers are also expected to be paid to committee members as follows: $7,500 for the audit committee, $3,750 for the compensation committee and $2,500 for the nominating/governance committee. Directors will also be reimbursed for expenses incurred in connection with their service as directors, including travel expenses for meeting attendance. We intend to continue to reimburse promptly all non-employee directors for reasonable expenses incurred to attend meetings of our board of directors or board committees. Other than as described above, we do not expect to provide any of our directors with any other compensation or perquisites.

Table of Contents

The following table sets forth compensation paid to our directors in their capacities as such in the fiscal year ended December 31, 2006.

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Option Awards ($)(1)	Non-Equity Incentive Plan Compen- sation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compen- sation ($)	Total ($)
Thomas D. Sullivan(2)							
Jeffrey W. Griffiths(2)							
Richard D. Tadler							
Martin F. Roper	$ 11,250		$ 12,335				$ 23,585
Douglas T. Moore	$ 11,250		$ 12,335				$ 23,585
John M. Presley	$ 11,250		$ 12,335				$ 23,585

(1) These options were granted under our 2006 Equity Plan for Non-Employee Directors and vest 25% on each of the first four anniversaries of grant, subject to acceleration in certain circumstances. The options have a strike price of $7.58 per share and expire July 13, 2016. Figures shown represent the dollar amounts of compensation cost recognized by us in 2006, in accordance with SFAS 123 (R), of director stock options. For a discussion of the assumptions relating to these valuations, which were based upon a third party valuation of our stock, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.

(2) We paid compensation to Messrs. Sullivan and Griffiths in their capacities as executive officers as detailed below.

2006 Equity Plan for Non-Employee Directors

Our 2006 Equity Plan for Non-Employee Directors, as amended effective October 18, 2006, provides for the grant of non-qualified stock options and restricted and unrestricted stock awards to non-employee directors. 200,000 shares are reserved for issuance under the plan, subject to adjustment to reflect changes in our stock due to corporate events such as reorganization, recapitalization, stock dividends, stock splits and reverse stock splits. The plan is administered by the board or a committee of the board composed of at least two directors (the 2006 Plan Committee). Fair market value is determined by the 2006 Plan Committee unless the stock is traded on a national securities exchange or automated quotation system, in which case the fair market value on any day will be the closing price reported on that day (except that on the first day on which the trading prices are so reported, the fair market value will be the price to the public stated in the final prospectus relating to our initial public offering). Options and restricted stock granted under the plan are non-transferable. At the request of a grantee and with the consent of the 2006 Plan Committee, grantees may receive a portion of cash compensation otherwise due to them in the form of unrestricted stock awards under the plan.

In the event of a 2006 Plan Sale Event (which includes our liquidation or dissolution, merger, sale of all or substantially all of our assets or a majority of our stock to an unrelated person, or any other transaction that results in a change ownership of a majority of voting control of us), the plan and all outstanding options terminate unless the parties to the transaction arrange to assume or continue the options following completion of the transaction. In the event of such a termination, holders will be given a specified period of time before the transaction to exercise outstanding options that are then exercisable or will become exercisable as of the effective time of the 2006 Plan Sale Event (subject to consummation of such 2006 Plan Sale Event). The board may amend or terminate the plan at any time, and the 2006 Plan Committee may amend or cancel any outstanding award, provided such action does not adversely affect the rights of the holder of any outstanding award without his or her consent.

Option grant agreements issued under the plan generally provide that options vest in four equal installments on the first four anniversaries of the applicable grant date, provided that (a) upon the occurrence of an initial public offering, vesting of the option will be accelerated by one year and (b) upon

80

Table of Contents

the occurrence of a 2006 Plan Sale Event, (i) 50% of the unvested portion of the option will vest and (ii) if the option is assumed or continued by us or any successor of us, the option will vest in full upon a termination of the optionee s service as a director within 18 months of such 2006 Plan Sale Event. Following a termination of the optionee s service as a director, the agreements generally provide that the option will remain exercisable (to the extent vested) for 12 months (in the case of the optionee s death or disability) or 90 days (in the case of termination of service as a director for any other reason). Shares acquired upon exercise of the option may be transferred only upon the optionee s death to his or her representatives, or to or for the benefit of certain family members, provided that we have a right of first refusal to purchase the shares prior to any such transfer. We also have the right to repurchase shares acquired through exercise of the option upon any termination of the optionee s service as a director or upon the optionee s bankruptcy, and have drag along rights in the event of certain events constituting a change in control of us. The transfer restrictions and drag along rights under the agreements terminate upon the occurrence of an initial public offering or 2006 Plan Sale Event.

2007 Plan

We expect to make future grants of stock options, restricted and unrestricted stock awards and other equity-based compensation to non-employee directors under our 2007 Plan. See Lumber Liquidators, Inc. 2007 Equity Compensation Plan below.

Compensation Discussion and Analysis

Our overall compensation philosophy is to maintain effective compensation programs that are as simple and flexible as possible, and permit us to make responsive adjustments to changing market conditions. We strive to provide our executive officers with compensation that is competitive within the industry and the executives geographic location in order to successfully attract and retain the key employees necessary to achieve the continued success of our business, being mindful of our desire to maintain low operating margins and control costs.

Prior to 2006, our founder and chairman of our board of directors (formerly our president and chief executive officer), Tom Sullivan, was responsible for making all non-equity based compensation decisions. Equity grants were not a regular part of our compensation program and very few equity grants had ever been made. In 2006, before Mr. Griffiths began serving as our chief executive officer, Mr. Sullivan continued to make all non-equity based compensation decisions, except for decisions regarding our annual bonus program, which were made in consultation with the board. Currently, Mr. Griffiths makes all non-equity based compensation decisions, subject to board oversight for annual bonus determinations. Equity grants are made by the board. As soon as practicable after the consummation of this offering, the compensation committee of our board of directors will assume responsibility for implementing and administering all aspects of our compensation and benefit plans and programs. We intend to have a compensation committee comprised solely of independent directors no later than the conclusion of the phase-in period required by the New York Stock Exchange for companies that are listing their shares in connection with an initial public offering.

Prior to 2004, our senior management consisted of Mr. Sullivan and a small team of executives at our Toano headquarters. In 2004, we began hiring additional members of senior management to manage our growth and strengthen our infrastructure with a view toward preparing for and consummating this offering, including the hiring or a new chief executive officer, a new chief information officer, a new vice president of operations and senior vice presidents of merchandising and direct marketing and advertising, during 2006 and 2007. By the end of 2006, we had significantly increased our senior management team at our Toano headquarters. As part of their respective compensation package, most of these new executives were granted stock options, which were intended to incentivize them to help achieve the successful completion of this offering and to strive to ensure our continued growth and success both before and after this offering.

Table of Contents

Following consummation of this offering, under the leadership of our compensation committee, we will continue to manage our compensation system with the following goals:

- to maintain a straightforward and flexible program that allows us to make adjustments in response to changes in market conditions;

- to provide compensation packages necessary to attract and retain key executives to help ensure that we remain competitive;

- to provide non-equity incentive compensation that depends on the executive s individual performance, and our financial performance, as compared against goals established by the compensation committee; and

- to provide an appropriate link between compensation and the creation of shareholder value through equity awards tied to our long-term performance.

Based on our overall compensation philosophy, our compensation program for senior management currently consists of only four basic elements to further and balance these goals:

- ***Base Salary.*** Existing compensation arrangements were negotiated with executives when they joined the company and, accordingly, we believe they reflect the compensation levels that were necessary to attract these executives. We intend to engage in benchmarking studies in the future to ensure that base salary levels remain competitive. We have not yet selected peer companies for these benchmarking purposes, although we currently expect to select peer companies from among those retail companies that have annual sales ranging from $150.0 million to $1.0 billion, with three- and five-year sales compound annual growth rates of at least 10%, but generally excluding those that are predominantly Internet- or catalog-based. In keeping with the theories underlying our commission-based compensation system for regional and store managers, our compensation for senior executives will continue to include performance-based compensation elements discussed below.

- ***Annual Cash Bonus Awards.*** Under our Annual Bonus Plan for Executive Management (the Bonus Plan), our senior executives are eligible to receive an annual incentive bonus awarded in cash. Bonuses will be tied to each executive s individual performance and our achievement of objective earnings thresholds, in each case as specifically tailored each year to reflect our then-current goals.

- ***Equity Incentive Awards.*** The long-term component of our compensation program consists of the grant of equity awards under our 2004 Stock Option and Grant Plan (the Option Plan), which are intended to create a mutuality of interest with shareholders by motivating our executive officers to manage our business so that our shareholders investment will grow in value over time.

- ***Performance-Based Commissions.*** Certain of our executives whose responsibilities relate directly to our sales are also eligible to receive commissions based on the sales levels we achieve.

We believe this system closely aligns our senior executives compensation with each executive s individual performance and with our performance on both a short-term and long-term basis and should assist us in attracting and retaining high-performing executives who will help us achieve continued success.

Base Salary. We are in the process of implementing annual performance reviews for senior management. Our president and chief executive officer, Jeffrey Griffiths, will conduct annual performance reviews of members of senior management, and our board will conduct annual evaluations of the chief executive officer s performance, in each case based on quantitative performance criteria such as sales, profitability and new account activity, and qualitative criteria such as business decisions, product and process suggestions and identification and development of business opportunities.

82

Table of Contents

Annual Cash Bonus Awards. Under the Bonus Plan, each executive officer is eligible to receive an annual cash bonus in an amount equal to a certain percentage of his or her base salary, based upon achievement of performance targets as set by the board of directors at the beginning of each calendar year. For calendar year 2006, performance targets for bonuses were based 50% on specified objective earnings thresholds for our audited earnings before income taxes, cash bonuses and non-cash stock compensation and 50% on a subjective analysis of individual operational goals established and/or approved by the chief executive officer (except for the chief executive officer, for whom the weighting was determined in the board s discretion).

The performance thresholds for the objective earnings component of our 2006 annual bonus plan were set in May 2006. This was the first time we set performance thresholds based on significant income statement or balance sheet line items, and it was done at a time when our budgeting process was still undergoing development. We believe that these objectives, as originally set, were aggressive and difficult to achieve. Shortly after the objectives were set, we made a number of changes to our operations, predominantly in connection with our transitioning toward becoming a public company, which made these objectives substantially more difficult to achieve. As a result, the original 2006 objectives do not reflect our current strategy or business model and are therefore not an appropriate benchmark against which to measure our past or future performance.

Our 2006 performance thresholds were as follows:

2006 Award Schedule	**% of Objective Portion of**
Earnings Thresholds	**Bonus Earned**
Up to $33,000,000	0
$33,000,000 or above	20%
$34,000,000 or above	40%
$35,700,000 or above	60%
$38,000,000 or above	70%
$39,000,000 or above	90%
$40,000,000 or above	100%

We did not have a specific bonus target for 2006. Our actual earnings (as calculated for purposes of making this determination) were below the minimum performance threshold, which we believe was principally due to the changes we made in our operations. Those changes, which included assembling an experienced executive team (including hiring a new chief executive officer), expanding our management team by hiring a number of senior vice presidents and a general counsel, restructuring our regional operations and increasing the number of regional managers, caused us to incur additional SG&A and other expenses during the period that had not been factored into our results in determining the objective performance thresholds. We also slowed the pace of new store openings to focus on expanding our store support infrastructure. See Management s Discussion and Analysis of Financial Condition and Results of Operations Overview.

Following are the target bonus amounts and actual bonus awards paid to each of these executive officers. We did not pay any portion of the bonus based on achievement of the objective earnings thresholds. The full amount of the bonus paid to each of these executive officers in 2006 was based solely upon satisfaction of the subjective individual operational goal criteria.

Executive	**2006 Target Annual Bonus Amount**	**2006 Actual Annual Bonus Award**
Mr. Sullivan	$ 300,000	$ 150,000
Mr. Griffiths	$ 142,466	$ 71,233
Mr. Terrell	$ 67,500	$ 33,750
Mr. Morrison	$ 206,250	$ 51,563
Mr. Pescara	$ 112,500	$ 42,188

Mr. Marcus	$	62,500	$	23,438
Mr. Greenan				

83

Table of Contents

In the future, our compensation committee will be responsible for establishing target bonus amounts and performance goals for executive bonuses. Factors to be considered may include, among other things, both quantitative performance criteria such as sales, profitability and new account activity, as well as qualitative criteria such as business decisions, product and process suggestions and identification and development of new business opportunities. While our board of directors is in the process of establishing 2007 bonus targets, no final determination has yet been made with respect to them.

Equity Incentive Awards. Our equity awards are designed to encourage executive officers to think and act like shareholders. We want our executive officers to take appropriate risks in order to generate returns for our shareholders and share in any adverse consequences if those risks cause poor performance or operating losses. The equity awards also reward longevity and increase retention, as we do not maintain a defined benefit pension plan or provide other post-retirement medical or life benefits. Because no benefit is received unless our stock price performs favorably over the term of the equity incentive award, such awards are intended to provide incentives for executive officers to enhance our long-term performance, as reflected in stock price appreciation over the long term, thereby increasing shareholder value. Prior to the consummation of this offering, the only equity awards granted to our executives are stock options that were awarded at the time the executives were hired. Future equity awards under the Option Plan may be in the form of stock options, restricted stock or unrestricted stock, as our compensation committee determines in its discretion.

As a private company, we limited the number of times per year that we granted options to our employees (including our executives) to coincide with the dates on which we received valuations of our common stock from third-party, independent firms. Our compensation committee will determine our practices for granting future equity awards to our executive officers and other employees following the consummation of this offering.

We intend to implement new equity compensation plans in connection with the completion of this offering.

Performance-Based Commissions. We may continue to provide executives whose responsibilities relate directly to our sales with the opportunity to earn commissions based on the sales performance of their respective areas of responsibility. However, as more fully described below, Mr. Greenan is no longer eligible to receive commission payments.

Internal Pay Equity. As described above, annual bonuses represent a significant portion of annual compensation for our executive officers. The target bonus for each executive officer is based on a percentage of his base salary. For our named executive officers who participated in the annual bonus program in 2006, target bonus percentages ranged from 100% of base salary for our current chief executive officer and former chief executive officer, Mr. Griffiths and Mr. Sullivan, respectively, to 50% of base salary for Messrs. Terrell, Pescara and Marcus, as discussed more fully below.

Half of each executive officer s annual bonus is based on the achievement by the company of objective performance targets. Accordingly, the level of achievement by the company will be the same for each of our executive officers, and will have the same impact on bonus compensation for all of our executive officers. The other half of the annual bonuses are linked to a subjective assessment of each executive s individual performance. In 2006, this assessment was performed by the board with respect to Messrs. Griffiths and Sullivan, and was performed by Messrs. Griffiths and Sullivan and approved by the board with respect to each of our other named executive officers. In the future, we intend to continue having the board or compensation committee approve annual bonus amounts payable to a select group of our top executive officers. We believe that basing a portion of the bonuses on achievement of

Table of Contents

company-wide performance targets incentivizes all of our executives to work together in the interests of promoting shareholder value. We also believe it is appropriate to base a portion of each named executive officer s bonus on that person s individual performance. As a result of the structure of our bonus program, a material portion of our executive compensation may vary significantly from individual to individual and from year to year.

Mr. Griffiths 2006 annual bonus target was 100% of his base salary. This bonus percentage was the result of negotiations between us and Mr. Griffiths at the time he commenced employment with us. His annual bonus, granted in accordance with the annual bonus program described above, was prorated based on the portion of the 2006 calendar year during which he served as chief executive officer. Mr. Griffiths 2006 compensation also included a one-time signing bonus of $100,000, as well as a commitment to propose a 745,000 option grant to Mr. Griffiths at the next meeting of the board, both of which he received pursuant to his employment agreement in September. The one-time signing bonus was intended to attract Mr. Griffiths to accept employment at Lumber Liquidators. The equity grant was intended to provide him with a significant stake in our long-term future performance as we prepared to launch this offering.

2006 annual bonus targets for our other executive officers were as follows: Mr. Sullivan, 100%; Mr. Terrell, 50%; Mr. Morrison, 75%; Mr. Pescara, 50% and Mr. Marcus, 50%. In light of Mr. Greenan s opportunity to earn a significant performance-based commission for 2006, as more fully described below, he was not eligible to participate in the 2006 annual bonus program. We believe that these target payment levels provide significant and appropriate incentives for each of these executive officers.

In addition, during fiscal year 2006, Mr. Greenan functioned to a significant extent as a regional manager and, as a result, we felt it was appropriate for his compensation to mirror the compensation of the regional store managers. As a result, he received commission payments based on store operations. As Mr. Greenan has transitioned to a more centralized managerial role, his overall compensation package more closely resembles the packages of the other executive officers and he is no longer eligible to receive commission payments. Similarly, Mr. Pescara participated in a commission program in 2006, and the commission payments comprised a portion of his compensation. Mr. Pescara will continue to participate in a commission arrangement as a result of his direct responsibility for sales.

Equity awards for 2006 were approved by the board. The number of options awarded to each of our named executive officers in 2006 (listed in the Summary Compensation Table below) was determined based on the executive s position in us and the length of his service to us.

Policy on Code Section 162(m). As a private company, prior to the consummation of this offering we were not subject to the limits on deductibility of compensation set forth in Section 162(m) of the Internal Revenue Code. Section 162(m) denies publicly-held companies a tax deduction for annual compensation in excess of $1.0 million paid to their chief executive officer or any of their four other most highly compensated executive officers employed on the last day of a given year, unless their compensation is based on qualified performance criteria. Subject to certain transition rules that apply to companies that first become publicly held in connection with an initial public offering such as this offering, to qualify for deductibility, these criteria must be established by a committee of independent directors and approved, as to their material terms, by that company s stockholders. In future years, we intend to structure our bonus and equity incentive programs so that they qualify as performance-based compensation under Section 162(m). However, our compensation committee may approve compensation or changes to plans, programs or awards that may cause the compensation or awards not to comply with Section 162(m) if it determines that such action is appropriate and in our best interests.

Table of Contents

Executive Compensation

Summary Compensation Table

The following table presents certain summary information concerning compensation paid to or earned by our president and chief executive officer, our former president and chief executive officer, our chief financial officer, our former chief financial officer and, each of our three other most highly compensated executive officers (determined as of the end of the last fiscal year) whose total annual salary and bonus exceeded $100,000 during the fiscal year ended December 31, 2006 (together referred to herein as Named Executive Officers).

Name and Principal Position	Year	Salary ($)	Bonus ($)	Option Awards ($)(1)	Non-Stock Incentive Plan Compensation ($)	All Other Compensation ($)	Total ($)
Thomas D. Sullivan Former president and chief executive officer; Chairman of our board of directors(2)	2006	299,091	150,000			9,205	458,296
Jeffrey W. Griffiths President and chief executive officer(3)	2006	144,230	171,233	174,609			490,072
Daniel E. Terrell Chief financial officer(4)	2006	134,750	33,750	53,651		2,605	224,756
Robert M. Morrison Senior vice president, store operations(5)	2006	274,055	51,563	53,651		5,298	384,567
Marco Q. Pescara Senior vice president, direct marketing and advertising(6)	2006	156,351	42,188	18,502	18,494	35,769	271,304
H. Franklin Marcus, Jr. Former chief financial officer; Vice president, finance; Treasurer(7)	2006	122,720	23,438	53,651		9,457	209,266
Tyler Greenan Vice president, store operations(8)	2006	47,730		160,952	282,952	12,799	504,433

(1) Represents the dollar amount of compensation cost recognized by us in 2006, in accordance with SFAS 123 (R), of employee stock options. For a discussion of the assumptions relating to these valuations, which were based upon a third party valuation of our stock, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.

(2) Mr. Sullivan stepped down as our president and chief executive officer effective September 18, 2006. He continues to serve as chairman of our board of directors. Compensation shown for Mr. Sullivan represents compensation for his services as president and chief executive officer. He did not receive compensation in 2006 for his services as a director. Mr. Sullivan remains employed by the company, and will continue to receive compensation in that capacity. All other compensation includes $2,605 in group health plan contributions and life insurance premiums and $6,600 in matching contributions to our 401(k) plan.

(3) Mr. Griffiths was hired to serve as our chief executive officer as of September 18, 2006.

(4) Mr. Terrell became our chief financial officer effective October 2006. All other compensation includes $2,605 in group health plan contributions and life insurance premiums.

(5) Mr. Morrison was hired to serve as our senior vice president, store operations as of January 2, 2006. All other compensation includes $5,298 in group health plan contributions and life insurance premiums.

(6) Mr. Pescara was hired to serve as our senior vice president, direct marketing and advertising as of April 20, 2006. The $18,494 represents a commission earned by Mr. Pescara. All other compensation includes reimbursement for $32,491 in relocation expenses and $3,278 in group health plan contributions and life insurance premiums.

86

Table of Contents

(7) Mr. Marcus stepped down as our chief financial officer effective October 2006. All other compensation includes $5,317 in group health plan contributions and life insurance premiums and $4,140 in matching contributions to our 401(k) plan.

(8) Non-Stock Incentive Plan Compensation represents a commission earned by Mr. Greenan. All other compensation includes $7,684 in group health plan contributions and life insurance premiums and $5,115 in matching contributions to our 401(k) plan.

Grants of Plan-Based Awards

The following table sets forth, for each of our Named Executive Officers, the grants of awards under any plan during the fiscal year ended December 31, 2006.

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards ($)			Estimated Future Payouts Under Equity Incentive Plan Awards (#)			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/Sh)	Grant Date Fair Value of Equity Awards(1)
Name	Grant Date	Threshold	Target	Max.	Threshold	Target	Max.				
Thomas D. Sullivan											
Jeffrey W. Griffiths	10/18/06								745,000	7.83	174,609
Daniel E. Terrell	7/13/06								114,761	7.58	53,651
Robert M. Morrison	7/13/06								114,761	7.58	53,651
Marco Q. Pescara	7/13/06								39,577	7.58	18,502
H. Franklin Marcus, Jr.	7/13/06								114,761	7.58	53,651
Tyler C. Greenan	7/13/06								344,282	7.58	160,952

(1) For a discussion of the assumptions relating to these valuations, which were based upon a third party valuation of our stock, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.

Discussion of the Summary Compensation Table and Grants of Plan-Based Awards Table

Employment Agreement with Jeffrey W. Griffiths. Pursuant to the employment agreement entered into between us and Jeffrey W. Griffiths, Mr. Griffiths is employed as our president and chief executive officer for a four-year term commencing September 18, 2006. The agreement provides for an annual base salary of $500,000, which may be increased based on an annual performance review. In addition, our board of directors in its discretion may award Mr. Griffiths an annual performance bonus, based on our financial performance and Mr. Griffiths job performance, as described in more detail under Compensation Discussion and Analysis above. Under the agreement, Mr. Griffiths was granted options to purchase 745,000 shares of our stock (approximately 3% of our outstanding shares at that time) at fair market value as of October 18, 2006 (determined based on a valuation of the stock as of October 1, 2006). The options vest 25% on each of the first four anniversaries of grant, provided that the options will become fully vested upon the occurrence of a Griffiths Agreement Sale Event (defined as (i) our dissolution or liquidation, (ii) a sale of all or substantially all of our assets or (iii) a merger, reorganization or consolidation in which our stock is converted into or exchanged for securities of a successor entity and the holders of a majority of voting power prior to the transaction do not hold a majority of voting power of the successor entity following the transaction). Mr. Griffiths also received a $100,000 signing bonus under the agreement after the first thirty days of his employment (all or half of which he would have been required to return to us if his employment was terminated for cause or if he resigned without good reason (each as defined in his employment agreement) within the first six months, or after the first six months but within the first eighteen months, of his employment, respectively).

87

Table of Contents

The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control. Mr. Griffiths is bound under the agreement by a confidentiality provision, and non-competition and non-solicitation clauses that apply to his employment and for a period of two years following the later of the date of termination of Mr. Griffiths employment and the date (if any) that a court enters a judgment enforcing the relevant provision.

Employment Agreement with H. Franklin Marcus, Jr. On August 27, 2004, we entered into an employment agreement with H. Franklin Marcus, Jr., our treasurer and vice president, finance and former chief financial officer. Under the agreement, Mr. Marcus base salary for his first year of employment was $125,000, subject to annual review.

Employment Arrangement with Tyler C. Greenan. In 2006, we amended our compensation arrangement with Mr. Greenan, our vice president, store operations. Accordingly, his base salary is now $230,000. He is eligible for an annual bonus as discussed in more detail in Compensation Discussion and Analysis above.

Offer Letter Agreement with Robert M. Morrison. On December 28, 2005, we entered into an offer letter agreement with Robert M. Morrison, our senior vice president, store operations. Under the agreement, Mr. Morrison s base salary for his first year of employment was $275,000. He is eligible for an annual bonus as discussed in more detail in Compensation Discussion and Analysis above. At the time of hiring, Mr. Morrison received an initial option grant to purchase 114,760 shares of our stock and reimbursement for moving expenses (up to a maximum of $125,000). The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control.

Offer Letter Agreement with Marco Q. Pescara. On March 27, 2006, we entered into an offer letter agreement with Marco Pescara, our senior vice president, direct marketing and advertising. Under the agreement, Mr. Pescara s base salary for his first year of employment was $225,000. He is also entitled to receive a 0.25% monthly commission based on our e-commerce sales (subject to adjustment based on annual review) and an annual bonus as discussed in more detail in Compensation Discussion and Analysis above. At the time of hiring, Mr. Pescara received reimbursement for moving expenses and an initial stock option grant covering shares valued at $300,000 at the time of the grant (based on a third-party valuation of our stock), which vests over a three-year period, provided that (a) vesting shall accelerate by one year upon completion of an initial public offering, (b) the options will become fully vested in the event of a 2004 Plan Sale Event (as defined below under the description of our 2004 Stock Option and Grant Plan) or a reorganization, recapitalization, reclassification, stock dividend, stock split or similar change in our stock that lowers our overall value (in which case, Mr. Pescara would be included in any cash distribution in the same manner as a stockholder). The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control.

2004 Stock Option and Grant Plan. Our 2004 Stock Option and Grant Plan, as amended effective October 18, 2006, provides for the grant of incentive and non-qualified stock options and restricted and unrestricted stock awards to officers, employees, consultants and other key persons (including prospective employees). There are 2,100,000 shares reserved for issuance under the plan, subject to adjustment to reflect changes in our stock due to corporate events such as reorganization, recapitalization, stock dividends, stock splits and reverse stock splits. The plan is administered by the board or a committee of the board selected by the board (the 2004 Plan Committee), provided that the 2004 Plan Committee may delegate authority to the chief executive officer to grant awards (up to a specified quantity) at fair market value pursuant to guidelines established by the 2004 Plan Committee for determining the exercise price of options, the conversion ratio or price of other awards, and vesting criteria. The exercise price for

Table of Contents

options granted under the plan must be at least fair market value on the applicable grant date. Fair market value is determined by the 2004 Plan Committee unless the stock is traded on a national securities exchange or automated quotation system, in which case the fair market value on any day will be the closing price reported on that day (except that on the first day on which the trading prices are so reported, the fair market value will be the price to the public stated in the final prospectus relating to our initial public offering). Options and restricted stock granted under the plan are non-transferable. At the request of a grantee and with the consent of the 2004 Plan Committee, grantees may receive a portion of cash compensation otherwise due to them in the form of unrestricted stock awards under the plan.

In the event of a 2004 Plan Sale Event (which includes our liquidation or dissolution, merger, sale of all or substantially all of our assets or a majority of our stock to an unrelated person, or any other transaction that results in a change in ownership of a majority of voting control of us), the plan and all outstanding options terminate unless the parties to the transaction arrange to assume or continue the options following completion of the transaction. In the event of such a termination, holders will be given a specified period of time before the transaction to exercise outstanding options that are then exercisable or will become exercisable as of the effective time of the 2004 Plan Sale Event (subject to consummation of such 2004 Plan Sale Event). The board may amend or terminate the plan at any time, and the 2004 Plan Committee may amend or cancel any outstanding award, provided such action does not adversely affect the rights of the holder of any outstanding award without his or her consent.

Option grant agreements issued under the plan typically provide that options vest in four equal installments on the first four anniversaries of the applicable grant date, provided that (a) upon the occurrence of an initial public offering, vesting of the option will be accelerated by one year and (b) upon the occurrence of a 2004 Plan Sale Event, (i) 50% of the unvested portion of the option will vest and (ii) if the option is assumed or continued by us or any successor of us, the option will vest in full upon a termination of the optionee s employment without cause or by the optionee for good reason (in each case, as defined in the option grant agreements) within 18 months following the 2004 Plan Sale Event. Following a termination of the optionee s employment, the agreements generally provide that the option will remain exercisable (to the extent vested) for 12 months (in the case of the optionee s death or disability) or 90 days (in the case of termination of employment for any other reason). Options terminate immediately upon a termination of the optionee s employment for cause. Shares acquired upon exercise of the option may be transferred only upon the optionee s death to his or her representatives, or to or for the benefit of certain family members, provided that we have a right of first refusal to purchase the shares prior to any such transfer. We also have the right to repurchase shares acquired through exercise of the option upon any termination of the optionee s employment or upon the optionee s bankruptcy, and have drag along rights in the event of certain events constituting a change in control of us. The transfer restrictions and drag along rights under the agreements terminate upon the occurrence of an initial public offering or 2004 Plan Sale Event. Optionees are generally bound under the agreements by confidentiality, non-solicitation (of both customers and employees) and non-competition provisions during the optionee s employment and for a period of 12 months following termination of his or her employment, violation of which would result in forfeiture of all unexercised options (whether or not vested) and all shares acquired upon the exercise of options.

Lumber Liquidators, Inc. 2007 Equity Compensation Plan. In August 2007, our board of directors adopted, and our shareholders approved, the Lumber Liquidators, Inc. 2007 Equity Compensation Plan (the 2007 Plan). The 2007 Plan will be administered by our compensation committee or such other committee as our board of directors will appoint from time to time to administer and to otherwise exercise and perform the authority and functions assigned to such committee (the Committee).

The purpose of the 2007 Plan is to encourage and enable the employees, non-employee directors and other service providers of Lumber Liquidators and our related companies upon whose judgment, initiative and efforts we largely depend for the successful conduct of our business, to acquire a proprietary interest in

Table of Contents

the company. It is anticipated that providing these persons with a direct stake in our welfare will assure a closer identification of their interests with our interests, thereby stimulating their efforts on our behalf and strengthening their desire to remain with us.

The material terms of the 2007 Plan are summarized below. The summary is not a complete description of the terms of the 2007 Plan.

Eligible Participants and Types of Awards. The 2007 Plan provides for the grant of non-qualified and incentive stock options (Options) and other stock-based awards, including without limitation restricted stock, restricted stock units, unrestricted stock awards and stock appreciation rights (Options and other stock based awards are referred to herein as the Awards) to our employees, non-employee directors and other service providers. Awards may be settled in cash or in shares or other property pursuant to the terms of the relevant Award.

Shares Available for Awards and Individual Award Limits. The number of shares of our common stock authorized for issuance with respect to Awards granted under the 2007 Plan (Shares) is 4,300,000, reduced by (i) any Shares that have been issued under either the 2004 Stock Option and Grant Plan and the 2006 Equity Plan for Non-Employee Directors (collectively, the Prior Plans), and (ii) any Shares that are subject to outstanding awards under the Prior Plans that have not been forfeited or cancelled. Of those Shares, the maximum number of Shares that may be covered by incentive stock options within the meaning of Section 422 of the Internal Revenue Code of 1986 may not exceed 4,300,000. Shares issued under the 2007 Plan may be either newly issued shares or treasury shares. No more than 1,500,000 Shares may be issued as restricted stock (either as a separate award or to settle restricted stock units) or unrestricted stock.

The maximum number of Shares that may be covered by Incentive Awards granted under the 2007 Plan to any single participant (a participant) in any calendar year may not exceed 400,000 Shares.

Shares covered by Awards will only be counted as used to the extent they are actually issued and delivered to a participant (or a participant s permitted transferees). Accordingly, if an Award is settled for cash or if Shares are withheld to pay the exercise price of an Option or to satisfy any tax withholding requirement in connection with an Award, only the Shares issued (if any), net of the Shares withheld, will be deemed delivered for purposes of determining the number of Shares that remain available for delivery under the 2007 Plan. In addition, if Shares are issued subject to conditions which may result in the forfeiture, cancellation or return of such Shares to us, any portion of the Shares forfeited, cancelled or returned will be treated as not issued pursuant to the 2007 Plan. Furthermore, Shares owned by a participant (or a participant s permitted transferees) are tendered (either actually or through attestation) to us in payment of any obligation in connection with an Award, the number of Shares tendered will be added to the number of Shares that are available for delivery under the 2007 Plan.

Shares covered by Awards granted pursuant to the 2007 Plan in connection with the assumption, replacement, conversion or adjustment of outstanding equity-based awards in the context of a corporate acquisition or merger will not count as used under the 2007 Plan for these purposes.

Effect on Prior Plans. No further awards will be granted under any of the Prior Plans following this offering.

Administration. The Committee will from time to time designate those persons who will be granted Awards and the amount, type and other terms and conditions of such Awards. The Committee has full authority to administer the 2007 Plan, including authority to interpret and construe any provision of the 2007 Plan and the terms of any Award issued under it and to adopt such rules and regulations for administering the 2007 Plan, as it may deem necessary. Pursuant to this authority, on or after the date of

Table of Contents

grant of an Award under the 2007 Plan, the Committee may (i) accelerate the date on which any such Award becomes vested, exercisable or transferable, as the case may be; (ii) extend the term of any such Award, including, without limitation, extending the period following a termination of a participant s employment during which any such Award may remain outstanding; (iii) waive any conditions to the vesting, exercisability or transferability, as the case may be, of any such Award; or (iv) provide for the payment of dividends or dividend equivalents with respect to any such Award; provided that the Committee will not have any such authority to the extent that the grant of such authority would cause any tax to become due under Section 409A of the Internal Revenue Code.

Significant Features of Awards. The following is a description of the terms that apply to each Option issued under the 2007 Plan. Each Option will entitle the holder thereof to purchase a specified number of Shares. The exercise price of each Option will be at least equal to 100% of the fair market value of a Share on the date on which the Option is granted. Options will have terms that may not exceed ten years and will have vesting periods as determined by the Committee. Each Option will be exercisable in whole or in part, but no partial exercise of an Option will be for an aggregate exercise price of less than an amount determined by the Committee from time to time. Each agreement evidencing the award of each Option will specify the consequences with respect to such Option of the termination of the employment, service as a director or other relationship between us and the participant.

The Committee may also grant equity-based or equity-related Awards other than Options in such amounts and subject to such terms and conditions as the Committee determines. Each such Award may, among other things, (i) involve the transfer of actual Shares, either at the time of grant or thereafter, or payment in cash or otherwise of amounts based on the value of Shares; (ii) be subject to performance-based and/or service-based conditions; and (iii) be in the form of stock appreciation rights, phantom stock, restricted stock, restricted stock units, performance shares, deferred share units, share-denominated performance units or other full value stock awards. With respect to Awards of restricted stock or restricted stock units, the 2007 Plan specifies that vesting restrictions conditioned on employment and the passage of time may not expire less than three years from the date of grant (except that up to 100,000 Shares may be granted with a restriction of no less than one year), and restrictions conditioned on the achievement of performance goals or conditions may not expire less than one year from the date of grant. The Committee may, however, provide that restrictions will expire at any time as a result of the Disability, death or retirement of the 2007 Plan service provider or the occurrence of a change in control of the company.

Performance-Based Compensation. The Committee may grant Awards that are intended to qualify under the requirements of Section 162(m) of the Internal Revenue Code as performance-based compensation. The performance goals upon which the payment or vesting of any Award (other than Options) that is intended to so qualify depends may relate to one or more of the following performance measures: (i) pre-tax earnings, as shown in our annual report to shareholders, calculated in accordance with generally accepted accounting principles consistently applied by us; (ii) earnings per share, as shown in our annual report to shareholders, calculated in accordance with generally accepted accounting principles consistently applied by us; (iii) earnings before interest, taxes, depreciation and amortization calculated in accordance with generally accepted accounting principles consistently applied by us; (iv) sales; (v) market share; (vi) stock price; (vii) cash flow(s) (including operating or net cash flow(s)); (viii) financial return ratios; (ix) return measures, including return or net return on assets, net assets, equity, capital or gross sales; (x) adjusted pre-tax margin; (xi) operating margins, operating profits, and/or operating expenses; (xii) dividends; (xiii) net income or net operating income; (xiv) value of assets; (xv) market penetration with respect to specific designated products or product groups and/or specific geographic areas; (xvi) aggregate product price and other product measures; (xvii) expense or cost levels; (xviii) reduction of losses, loss ratios or expense ratios; (xix) reduction in fixed costs; (xx) operating cost management; (xxi) cost of capital; (xxii) debt reduction; (xxiii) productivity improvements; (xxiv) average inventory turnover; (xxv) satisfaction of specified business expansion goals or goals relating to acquisitions or divestitures; (xxvi) advertising efficiency; (xxvii) customer satisfaction based on specified objective goals or a company-sponsored customer survey; (xxviii) employee diversity goals or employee turnover; (xxix) supervision of litigation and information technology; and (xxx) goals relating to acquisitions or divestitures of subsidiaries or joint ventures. The targeted level or levels of performance with respect to such business criteria may be established at such levels and in such terms as the Committee may determine, in its discretion, including in absolute terms, on a per share basis (either basic or diluted), as a goal relative to performance in prior periods, or as a goal compared to the performance of one or more comparable companies or an index covering multiple companies.

Within 90 days after the beginning of a performance period, and in any case before 25% of the performance period has elapsed, we expect that the Committee will establish (i) performance goals and objectives for such performance period; (ii) target awards for each participant; and (iii) performance schedules or other objective methods for determining the applicable performance percentage to be applied to each such target award.

General Plan Provisions. The 2007 Plan provides for an adjustment in the number of Shares available to be issued under the 2007 Plan, the number of Shares subject to Awards and the exercise prices of certain Awards upon a change in our capitalization, a stock dividend or split, a merger or combination of Shares and certain other similar events.

The 2007 Plan also provides that participants may elect to satisfy certain federal income tax withholding requirements by remitting to us cash or, subject to certain conditions, Shares or by instructing us to withhold Shares payable to the participant.

Under the 2007 Plan, Awards may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution, except as permitted by the Committee on a general or specific basis.

Our board of directors may at any time suspend or discontinue the 2007 Plan or revise or amend it in any respect whatsoever, except that, no change shall be made that increases the total number of Shares reserved for Awards, materially modifies the requirements as to eligibility for participation in the 2007 Plan or materially increases the benefits accruing the participants in the 2007 Plan unless such change is approved by our shareholders, unless we or the Committee determines that no such shareholder approval is required under any applicable law, regulation or rule of a stock exchange applicable to the 2007 Plan.

We will not make any grants of Awards under the 2007 Plan following the tenth anniversary of the date that the 2007 Plan becomes effective.

The 2007 Plan provides for or permits accelerated vesting of certain types of Awards under certain circumstances in connection with a change in control of the company.

Tax Consequences of the 2007 Plan. The tax consequences of participation in the 2007 Plan for participants and us generally depend on the type of award issued to a participant. In general, if a participant recognizes ordinary income in connection with the grant, vesting or exercise of an award, we are entitled to a corresponding deduction equal to the amount recognized as income by the participant.

Table of Contents

Outstanding Equity Awards at Fiscal Year-End

The following table sets forth, for each of our Named Executive Officers, the outstanding equity awards as of the end of the fiscal year ended December 31, 2006.

	Option Awards					Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) (1)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)
as an									
y ns		745,000	745,000	7.83	10/18/2016				
l E. l		114,761	114,761	7.58	7/13/2016				
rt son		114,761	114,761	7.58	7/13/2016				
o Q. ara		39,577	39,577	7.58	7/13/2016				
lin us,		114,761	114,761	7.58	7/13/2016				
C. nan		344,282	344,282	7.58	7/13/2016				

(1) Options shown were granted under our 2004 Stock Option and Grant Plan. The options held by each Named Executive Officer other than Mr. Pescara vest 25% on each of the first four anniversaries of grant. Mr. Pescara s options vest in three equal annual installments on the first three anniversaries of grant.

Option Exercises and Stock Vested

No Named Executive Officer exercised stock options, stock appreciation rights or similar instruments, and no equity-based awards vested, during the fiscal year ended December 31, 2006.

Potential Payments Upon Termination or Change of Control

Under his employment agreement, in the event of his disability or death, Mr. Griffiths is entitled to receive a prorated portion of his annual performance bonus. If (a) we terminate Mr. Griffiths employment without Cause (as defined in his agreement), (b) Mr. Griffiths terminates his employment within 60 days following a Griffiths Agreement Sale Event (as defined above under the description of Mr. Griffiths employment agreement) that results in a material reduction in his compensation or responsibilities or (c) Mr. Griffiths terminates his employment for Good Reason (as defined in his agreement), Mr. Griffiths is entitled to receive two times his base salary in either a lump sum or installments (at his election) and a prorated portion of his annual performance bonus. Upon the occurrence of a Griffiths Agreement Sale Event, Mr. Griffiths options will become fully vested.

Under his offer letter agreement, if Mr. Morrison is terminated without cause prior to December 28, 2007, he is entitled to receive severance equal to his annual salary.

Under Mr. Pescara s offer letter agreement, if he is terminated other than for cause (as defined in his agreement), he would be entitled to receive a severance payment equal to one year s base salary, projected commissions and bonus. If the termination occurs within 24 months following a sale of us, he would be entitled to receive 18 months base salary, projected commissions and bonus. In addition, the options granted to Mr. Pescara at the time he was hired (shown above in the Outstanding Equity Awards at Fiscal Year-End table) would become fully vested in the event of a 2004 Plan Sale Event (as defined above under the description of our 2004 Stock Option and Grant Plan) or a reorganization,

Table of Contents

recapitalization, reclassification, stock dividend, stock split or similar change in our stock that lowers our overall value (in which case, Mr. Pescara would be included in any cash distribution in the same manner as a stockholder).

Our other Named Executive Officers are not entitled to any severance payments upon termination of their employment or in connection with a change in control of us. If a change in control occurs, which constitutes a 2004 Plan Sale Event (as defined above under the description of our 2004 Stock Option and Grant Plan), the options held by our Named Executive Officers, as set forth in the Outstanding Equity Awards at Fiscal Year-End table above (other than options held by Mr. Griffiths and Mr. Pescara, which would vest pursuant to their respective employment and offer letter agreements as described above) would vest with respect to 50% of the unvested portion of the options. If such options were not assumed by us or a successor of us, the options would terminate upon the occurrence of a 2004 Plan Sale Event and optionees would be given a specified period of time prior to the transaction to exercise outstanding options that were then exercisable or (subject to consummation of the 2004 Plan Sale Event) that would become exercisable as of the effective time of the 2004 Plan Sale Event. If the options were assumed or continued by us or any successor of us, they would become fully vested if the optionee s employment were terminated without cause or by the optionee for good reason (in each case, as defined in the applicable stock option grant agreements) within 18 months following the 2004 Plan Sale Event. If a change in control that constituted a 2004 Plan Sale Event occurred as of December 31, 2006, the option spread for the options held by each of our Named Executive Officers would have been as follows: Mr. Griffiths, $1,341,000; Mr. Terrell, $117,630; Mr. Morrison, $117,630; Mr. Pescara, $81,133; Mr. Marcus, $117,630; Mr. Greenan, $352,889.

Other Agreements with Executive Officers

We have entered into employment agreements with Jeffrey W. Griffiths, H. Franklin Marcus, Jr., Robert M. Morrison and Marco Q. Pescara. For a summary of these agreements, see Executive Compensation Discussion of the Summary Compensation Table and Grants of Plan-Based Awards Table.

We have entered into employee confidentiality and non-compete agreements with certain of our executive officers, and we have entered into stock option agreements containing certain restrictive covenants with other of our executive officers, and we have entered into both agreements with two of our executive officers. Each employee confidentiality and non-compete agreement provides that the executive generally will not disclose, either during or after employment, our proprietary information, and will not compete with us or solicit our customers, suppliers or employees for the duration of the executive s employment and for a period of 24 months following termination of employment. The restrictive covenants of each stock option agreement provide that the executive generally will not disclose our proprietary information, compete with us or solicit our customers, suppliers or employees for the duration of the executive s employment and for a period of 12 months following termination of employment.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

Lease Arrangements

We currently lease our Toano facility, which includes a store location, and 23 of our other store locations from ANO LLC (ANO), a company that is wholly owned by Tom Sullivan, our founder and the chairman of our board of directors. We leased 22, 19 and 9 of our other stores from ANO as of December 31, 2006, 2005 and 2004, respectively. These leases generally have five-year base periods and multiple five-year renewal periods. We also lease our Toano finishing, distribution and headquarters facility from ANO under an operating lease with a base period that runs through December 31, 2019. Our rent expense attributable to ANO was $2.1 million, $2.0 million and $1.0 million in 2006, 2005 and 2004, respectively. Our future minimum lease payments to ANO under all of our leases with them were $18.2 million as of September 30, 2007. These leases are described in more detail in Note 6 to our audited financial statements included elsewhere in this prospectus.

We also currently lease one store location each from DORA Real Estate Company, LLC (DORA), Wood on Wood Road, Inc. (Wood on Wood) and BMT Holdings, LLC (BMT). DORA and Wood on Wood are wholly owned by Tom, and he has a 50% membership interest in BMT. Each lease is for a five-year base period and has a five-year renewal period. The lease with BMT is currently in the first year of its renewal period. Our rent expense attributable to DORA was $0.02 million in each of 2006, 2005 and 2004. Our rent expense attributable to Wood on Wood was $0.07 million in each of 2006, 2005 and 2004. Our rent expense attributable to BMT was $0.05 million in each of 2006, 2005 and 2004.

We believe that the leases that we have signed to date with ANO, DORA, Wood on Wood and BMT are on fair market terms, and the shareholders agreement to which Tom and TA Associates are parties prevents entities affiliated with Tom from setting lease rates above market rates.

In addition, of our leases with lessors that are not owned in whole or in part by Tom, three were guaranteed by Tom as of September 30, 2007.

We have adopted new approval policies for related party transactions in connection with this offering. Pursuant to those policies, transactions between us and our directors, officers and employees are generally required to be approved by the disinterested members of the Board of Directors (or, once it has been formed, the audit committee). See Policy Concerning Related Party Transactions below.

Investment By TA Associates

In December 2004, we sold 7,952,018 shares of our series A convertible preferred stock for an aggregate amount of $35 million (the Preferred Stock Purchase) to TA IX L.P., TA/Atlantic and Pacific IV L.P., TA Strategic Partners Fund A L.P., TA Strategic Partners Fund B L.P. and TA Investors II L.P. (collectively, the TA Associates Funds). TA Associates, Inc. (TA Associates) is the ultimate general partner or manager of each of the TA Associates Funds, and Richard Tadler, one of our directors, is a managing director of TA Associates. After the Preferred Stock Purchase, TA Associates was the only holder of our series A convertible preferred stock. In connection with the closing of this offering, TA Associates will convert all of its shares of preferred stock into common stock based on a formula set forth in our restated articles of organization. The conversion ratio as of the date of this prospectus was one-to-one. Accordingly, TA Associates will receive 7,952,018 shares of common stock upon conversion of all the series A convertible preferred stock. TA Associates will sell 2,566,667 shares of common stock in this offering.

Table of Contents

Stockholders Agreement

In connection with the Preferred Stock Purchase, we entered into a stockholders agreement with Tom Sullivan and the TA Associates Funds relating to our shares of common stock, preferred stock and any other equity securities that we may issue and they may hold (collectively, the Agreement Shares). Among other things, the stockholders agreement places certain restrictions on the ability of Tom and the TA Associates Funds to transfer their Agreement Shares, gives rights of first refusal to the TA Associates Funds, Tom and, in certain circumstances, us, with respect to Agreement Shares sold by the TA Associates Funds or Tom and allows the TA Associates Funds, in certain circumstances, to sell their Agreement Shares in conjunction with a sale of Agreement Shares by Tom. In addition, the TA Associates Funds have preemptive rights in certain circumstances upon a sale by us of certain securities, including shares of our common stock. The stockholders agreement provides that we shall have five directors, one of whom shall be nominated by the TA Associates Funds and two of whom shall be nominated by Tom. The remaining two directors are independent, and both shall be nominated by Tom but must be deemed acceptable by the TA Associates Funds. Finally, among other things, we covenanted to furnish certain reports and financial statements to the TA Associates Funds, maintain certain insurance, permit certain inspections of our premises and obtain certain employee agreements. Except for certain covenants relating to liability insurance for directors and officers, compensation of directors and the provision of information to investors regarding certain tax matters, the provisions of the stockholders agreement relating to restrictions on transfer terminate upon the commencement of, and the remaining provisions of the stockholders agreement terminate upon the closing of, a Qualified Public Offering (as defined in our restated articles of organization). Although this offering is not expected to qualify as a Qualified Public Offering, we nonetheless expect to amend the stockholders agreement in connection with this offering.

Registration Rights Agreement

In connection with the Preferred Stock Purchase, we entered into a registration rights agreement with the TA Associates Funds relating to our shares of common stock held by the TA Associates Funds at any time. Subject to certain exceptions, including our right to defer a demand registration under certain circumstances, the TA Associates Funds have the right under the registration rights agreement to require us to register for public sale under the Securities Act all shares of common stock that they request be registered at any time following the expiration of the lock-up period in connection with this offering. After this offering, we are required to use our best efforts to qualify and remain qualified to register securities pursuant to a registration statement on Form S-3 under the Securities Act. The TA Associates Funds will also be entitled to piggyback registration rights with respect to any future registration statement we file for an underwritten public offering of securities. Under the registration rights agreement, we are responsible, subject to certain exceptions, for the expenses of any offering of the shares of the TA Associates Funds. The TA Associates Funds are subject to lock-up agreements for a period of 180 days following the date of this prospectus. The registration rights agreement does not include a liquidated damages clause and provides no penalty for liquidated damages.

Other Matters Involving Tom Sullivan

We are party to the Variable Plan, a stock-based agreement between Tom Sullivan and Kevin Sullivan, Tom s brother, who started our western U.S. operations and was our first regional manager, pursuant to which we generally guarantee Tom s cash payment obligation under the agreement. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended in August 2005, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria. The number of shares that may be acquired pursuant to the Variable Plan, shall be determined immediately prior to the completion of this offering, and will equal the sum of (a) a number of shares of common stock equal to 2.5% of our outstanding common stock, determined on a fully diluted basis and (b) a number of shares of common stock having an aggregate value equal to 10.5% of the value of the Western Region of

Table of Contents

the company. For purposes of the Variable Plan, the Western Region means our operations in eleven western U.S. states as of August 1, 2005, together with certain additional specified operations in those states, subject to adjustment in certain circumstances. The value of the Western Region will be determined by multiplying the fair market value of the company by a fraction, the numerator of which is the net income of the Western Region for the immediately preceding 12 months (or portion thereof) and the denominator of which is our net income for the same period, in each case determined in accordance with generally accepted accounting principles consistently applied. We estimate that the number of shares that would have been issued to Kevin pursuant to the Variable Plan had the option been exercised on September 30, 2007 would have been approximately 926,000 shares. This right is exercisable for shares of common stock, to be contributed by Tom and which have been placed in escrow, in conjunction with an IPO or sales event. Kevin s right under the Variable Plan will be considered to be exercised in full immediately prior to the completion of the initial public offering and, accordingly, we do not expect to record any future charges relating to the Variable Plan other than an adjustment in connection with the IPO of $(150,000) (based on the midpoint of the range shown on the cover page of this prospectus and our preliminary estimate of 926,000 shares earned) in the quarter of 2007 in which this transaction closes. See Management s Discussion and Analysis of Financial Condition and Results of Operations Other Factors Affecting Our Results Equity Compensation Expenses.

The Variable Plan also contains various customary representations and warranties, put and call rights, termination provisions, certain lock-up provisions, and certain provisions that will terminate in connection with this offering, including a right of first refusal for Tom with respect to any disposal of the shares acquired by Kevin and a drag-along right in connection with various strategic transactions.

In 2004, we distributed cash of $42.6 million to Tom, of which $12.6 million consisted of cash distributions immediately prior to the TA Associates transaction, including $5.0 million to enable him to pay taxes on deemed income during the period when we were an S corporation, and a $30.0 million distribution related to the Preferred Stock Purchase. See Dividend Policy. In addition, pursuant to the terms of the Preferred Stock Purchase, Tom assumed a net liability related to a capitalized lease, and we recorded a $0.6 million contribution from him in 2005.

As of December 31, 2006, Tom owed us approximately $35,000 in connection with his personal use of our company s corporate credit card, which was paid in the first quarter of 2007. As of the date of this filing, Tom did not have an outstanding balance to us.

Policy Concerning Related Party Transactions

In connection with this offering, we have adopted a formal written policy concerning related party transactions. A related party transaction is a transaction, arrangement or relationship involving us or a consolidated subsidiary (whether or not we or the subsidiary is a direct party to the transaction), on the one hand, and (i) a director, executive officer or employee of us or a consolidated subsidiary, his or her immediate family members or any entity that any of them controls or in which any of them has a substantial beneficial ownership interest; or (ii) any person who is the beneficial owner of more than 5% of our voting securities or a member of the immediate family of such person.

The audit committee established prior to this offering (and, prior to that time, the disinterested members of the board of directors) evaluates each related party transaction for the purpose of recommending to the disinterested members of the board whether the transaction is fair, reasonable and within our company s policy, and should be ratified and approved by the board. At least annually, management will provide the audit committee or disinterested members of the board of directors, as the case may be, with information pertaining to related party transactions. Related party transactions entered into, but not approved or ratified as required by our policy concerning related party transactions, will be subject to termination by us or the relevant subsidiary, if so directed by the audit committee or the board, taking into account factors as such body deems appropriate and relevant.

Table of Contents

PRINCIPAL AND SELLING STOCKHOLDERS

The following tables set forth information known to us regarding beneficial ownership of our common stock as of September 30, 2007, by:

- each person, or group of affiliated persons, who beneficially owns more than 5% of our outstanding shares of common stock;
- each stockholder selling shares in this offering;
- each of our named executive officers;
- each of our directors; and
- all of our executive officers and directors as a group.

Except as otherwise set forth in the footnotes below, and subject to applicable community property laws, to our knowledge, each person has sole voting and investment power over the shares shown as beneficially owned. See Certain Relationships and Related Party Transactions for a discussion of business relationships between us and certain of our stockholders, and Management Executive Officers and Directors for the positions and offices held by certain stockholders.

The number of shares beneficially owned by each stockholder is determined under rules promulgated by the SEC and generally includes voting or investment power over the shares. The table below assumes the underwriters do not exercise their option to purchase additional shares. The information does not necessarily indicate beneficial ownership for any other purpose. Under SEC rules, the number of shares of common stock deemed outstanding includes shares issuable upon exercise of options held by the respective person or group which may be exercised within 60 days after September 30, 2007. For purposes of calculating each person s or group s percentage ownership, shares of common stock issuable pursuant to stock options exercisable within 60 days after September 30, 2007 are included as outstanding and beneficially owned for that person or group but are not treated as outstanding for the purpose of computing the percentage ownership of any other person or group.

As of September 30, 2007, there were 22,952,118 shares of our common stock outstanding (assuming the conversion into shares of common stock of all shares of our series A preferred stock currently held by the TA Associates Funds). Assuming the completion of the various transactions described in this prospectus, there will be 26,752,118 shares of common stock outstanding upon completion of this offering. Unless otherwise indicated in the footnotes, the address of each beneficial owner listed below is c/o Lumber Liquidators, Inc., 3000 John Deere Road, Toano, Virginia 23168.

Table of Contents

Beneficial Owner	Number of Shares Beneficially Owned Before the Offering	% of Outstanding Common Stock Before the Offering	Number of Shares of Common Stock Offered Hereby	Number of Shares Beneficially Owned After the Offering(1)	% of Outstanding Common Stock After the Offering(1)
TA Associates Funds(2)(3)	7,952,018	34.6%	2,566,667	5,385,351	20.1%
Thomas D. Sullivan(4)	15,000,100	65.4%	5,133,333	8,940,767	33.4%
Jeffrey W. Griffiths.	0	*	0	*	*
Douglas T. Moore	0	*	0	*	*
John M. Presley	0	*	0	*	*
Martin F. Roper	0	*	0	*	*
Richard D. Tadler(5)	7,952,018	34.6%	2,566,667	5,385,351	20.1%
Daniel E. Terrell	0	*	0	*	*
E. Livingston B. Haskell	0	*	0	*	*
Rick A. Boucher	0	*	0	*	*
Robert M. Morrison	0	*	0	*	*
Marco Q. Pescara	0	*	0	*	*
Andrew P. Shulklapper	0	*	0	*	*
Kenneth M. Strohschein	0	*	0	*	*
H. Franklin Marcus, Jr.	0	*	0	*	*
Tyler C. Greenan	0	*	0	*	*
All executive officers and directors as a group (15 persons)	22,952,118	100.0%	7,700,000	14,326,118	53.5%

* Represents beneficial ownership of less than 1%.

(1) Assumes no exercise of the underwriters option to purchase additional shares. In the event that option is exercised in full, TA Associates Funds and Richard Tadler would each beneficially own 4,810,351 shares of common stock, representing 18.0% of the outstanding common stock after the offering, and Tom Sullivan would beneficially own 7,790,767 shares of common stock, representing 29.1% of the outstanding common stock after the offering. In such a case, the percentage of the outstanding shares of common stock beneficially owned by our directors and officers as a group after the offering would be 50.6%.

(2) Represents shares held by TA IX L.P., TA/Atlantic and Pacific IV L.P., TA Strategic Partners Fund A L.P., TA Strategic Partners Fund B L.P. and TA Investors II L.P. (the TA Associates Funds) TA Associates, Inc. is the ultimate general partner or manager of each of such entity. Investment and voting control of the TA Associates Funds is held by TA Associates, Inc. No stockholder, director or officer of TA Associates, Inc. has voting or investment power with respect to our shares of common stock held by the TA Associates Funds. Voting and investment power with respect to such shares is vested in a four-person investment committee consisting of the following employees of TA Associates, Inc.: Jonathan M. Goldstein, A. Bruce Johnston, C. Kevin Landry and Richard D. Tadler. The address of each TA Associates Fund and of TA Associates, Inc. is 200 Clarendon Street, 56th Floor, Boston, Massachusetts 02116.

(3) The number of shares of common stock attributed to the TA Associates Funds gives effect to the conversion of each share of series A preferred stock currently held by the TA Associates Funds into shares of common stock in connection with this offering.

(4) With respect to shares owned after the offering, reflects the transfer of an estimated 926,000 shares from Mr. Sullivan to Kevin Sullivan pursuant to the Variable Plan as a result of the initial public offering.

(5) Mr. Tadler is a managing director of TA Associates, Inc, which is the ultimate general partner or manager of each of the TA Associates Funds. Mr. Tadler may be deemed to be the beneficial owner of 7,952,018 shares of the post-conversion shares of common stock that will be held by the TA Associates Funds. Mr. Tadler disclaims beneficial ownership of any securities beneficially owned by the TA Associates Funds.

99

Table of Contents

DESCRIPTION OF CAPITAL STOCK

General

We were incorporated in Massachusetts in 1994, and, reincorporated in Delaware in August 2007 in connection with this offering. The following discussion is a summary of the terms of our capital stock, our certificate of incorporation and our bylaws following certain amendments that we intend to make in connection with this offering, as well as certain applicable provisions of Delaware law. Forms of our certificate of incorporation and bylaws as they will be in effect following this offering will be filed as exhibits to the registration statement of which this prospectus is a part.

Common Stock

Upon the consummation of this offering, our authorized capital stock will consist of 35,000,000 shares of common stock, which will have a par value of $0.001 per share. Following the consummation of this offering, we will have 26,752,118 shares of common stock outstanding. Prior to this offering, there is one holder of our common stock and one holder of series A preferred stock that is convertible into our common stock.

Holders of common stock will be entitled to one vote for each share held on all matters submitted to a vote of stockholders and do not have cumulative voting rights. Accordingly, holders of a majority of the shares of common stock entitled to vote in any election of directors may elect all of the directors standing for election. In addition, holders of common stock are entitled to receive proportionately any dividends that may be declared by our board of directors, subject to any preferential dividend rights of outstanding preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights.

In the event of any reorganization of Lumber Liquidators with one or more corporations or a merger or share exchange of Lumber Liquidators with another corporation in which shares of our common stock are converted into or exchangeable for shares of stock, other securities or property, including cash, all holders of our common stock will be entitled to receive with respect to each share held the same kind and amount of shares of stock and other securities and property, including cash. Upon our liquidation, dissolution or winding up, the holders of common stock are entitled to receive proportionately our net assets available after the payment of all debts and other liabilities and subject to the prior rights of any outstanding preferred stock.

Our outstanding shares of common stock are, and the shares offered by us in this offering will be, when issued and paid for, validly issued, fully paid and nonassessable. The rights, preferences and privileges of holders of common stock are subject to, and may be impacted by, the rights of the holders of shares of any series of preferred stock that we may designate and issue in the future.

Preferred Stock

Our certificate of incorporation will authorize the issuance of an aggregate of 8,000,000 shares of preferred stock. Prior to the consummation of this offering, there were 7,952,018 shares of our series A preferred stock outstanding. We expect that all outstanding shares of series A preferred stock will be converted into common stock in connection with this offering. Upon the consummation of those transactions, there will be no shares of preferred stock outstanding.

Table of Contents

Our board of directors may, from time to time, direct the issue of shares of preferred stock in series and may, at the time of issue, determine the designation, powers, rights, preferences and limitations of each series. Satisfaction of any dividend preferences of outstanding preferred stock would reduce the amount of funds available for the payment of dividends on shares of common stock. Holders of preferred stock may be entitled to receive a preference payment in the event of any liquidation, dissolution or winding-up of Lumber Liquidators before any payment is made to the holders of common stock. Under certain circumstances, the issuance of preferred stock may render more difficult or tend to discourage a merger, tender offer or proxy contest, the assumption of control by a holder of a large block of securities of Lumber Liquidators or the removal of incumbent management. Upon the affirmative vote of a majority of the total number of directors then in office, the board of directors may issue shares of preferred stock with voting and conversion rights that could adversely affect the holders of shares of common stock.

Pre-emptive Rights

Our shareholders are not entitled to pre-emptive rights to subscribe for additional issuances of common stock or any other class or series of common stock or any security convertible into such stock.

Certain Certificate of Incorporation and Bylaw Provisions

Our certificate of incorporation will provide for the board to be divided into three classes, as nearly equal in number as possible, serving staggered terms. About one-third of the board will be elected annually, and each member will serve a three-year term. The provision for a classified board could prevent a party who acquires control of a majority of the outstanding voting shares from obtaining control of the board until the second annual shareholders meeting following the date the acquirer obtains the controlling share interest. The classified board provision is designed to have the effect of discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of Lumber Liquidators and to increase the likelihood that incumbent directors will retain their positions. Under Delaware law, directors of a corporation with a classified board may only be removed for cause unless the certificate of incorporation provides otherwise. Our certificate of incorporation does not provide that our shareholders can remove the directors without cause.

Our certificate of incorporation will provide that shareholder action can be taken only at an annual or special meeting of shareholders and cannot be taken by written consent in lieu of a meeting. Our bylaws provide that, except as otherwise required by law, annual or special meetings of the shareholders can only be called pursuant to a resolution adopted by a majority of the total number of directors then in office or by the chairman of the board. Shareholders are not permitted to call a general meeting or to require the board of directors to call a general meeting. The bylaws establish an advance notice procedure for shareholder proposals to be brought before a general meeting of shareholders, including proposed nominations of persons for election to the board of directors. Shareholders at a general meeting may only consider proposals or nominations specified in the notice of meeting or brought before the meeting by or at the direction of the board of directors or by a shareholder who was a shareholder of record on the record date for the meeting, who is entitled to vote at the meeting and who has given timely written notice, in proper form, of the shareholder s intention to bring that business before the meeting. Although neither the certificate of incorporation nor the bylaws gives the board of directors the power to approve or disapprove shareholder nominations of candidates or proposals about other business to be conducted at a general meeting, the certificate of incorporation and the bylaws may have the effect of precluding the conduct of certain business at a meeting if the proper procedures are not followed or may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect its own slate of directors or otherwise attempting to obtain control of Lumber Liquidators.

Table of Contents

We expect the certificate of incorporation to provide that the provisions of Section 203 of the Delaware General Corporation Law, which relate to business combinations with interested shareholders, will apply to Lumber Liquidators. Section 203 provides that, subject to certain exceptions, an interested stockholder of a Delaware corporation may not engage in any business combination, including mergers or consolidations or acquisitions of additional shares of the corporation, with the corporation for a three-year period following the date that the stockholder becomes an interested stockholder. Under Section 203, an interested stockholder is a person who, together with affiliates and associates, owns or, in some cases, within three years prior owned, 15% or more of the corporation s voting stock.

Our board of directors will be permitted to alter certain provisions of our bylaws without obtaining shareholder approval.

Limitation of Liability and Indemnification of Officers and Directors

Our certificate of incorporation will provide that no director shall be liable to us or our stockholders for monetary damages for breach of fiduciary duty as a director, except as required by the Delaware General Corporation Law as in effect from time to time. Our bylaws will provide that, to the full extent permitted by law, we will indemnify any person made or threatened to be made a party to any action by reason of the fact that the person is or was our director or officer, or serves or served as a director or officer of any other enterprise at our request.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is Computershare Investor Services, LLC.

Listing

We will apply to list our common stock on the New York Stock Exchange under the symbol LL.

Table of Contents

SHARES ELIGIBLE FOR FUTURE SALE

Prior to this offering, there has been no public market for our common stock. Upon completion of this offering, we will have outstanding an aggregate of 26,752,118 shares of common stock, assuming no exercise of outstanding options. All of the shares sold in this offering will be freely tradable without restriction or further registration under the Securities Act, except that any shares purchased by our affiliates, as that term is defined in Rule 144, may generally only be sold in compliance with the limitations of Rule 144, which is summarized below. We are not aware of any of our affiliates who will acquire shares in this offering. On that basis, all of the remaining shares of our common stock that are outstanding upon completion of this offering, or 15,252,118 shares, will be restricted shares under the terms of the Securities Act and may be eligible for sale as described below 180 days after the date of the final prospectus following the expiration of lock-up agreements between our officers, directors and stockholders and the underwriters. Goldman, Sachs & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, in their sole discretion, may release any of the securities subject to these lock-up agreements without notice at any time.

Sales of Restricted Securities

Restricted shares may be sold in the public market only if they are registered under the Securities Act or if they are sold pursuant to an exemption from registration, such as the exemptions provided by Rule 144, 144(k) or 701 promulgated under the Securities Act, each of which is summarized below.

In general, under Rule 144 as currently in effect, beginning 90 days after the date of this prospectus a person who has beneficially owned restricted shares for at least one year and has complied with the requirements described below would be entitled to sell within any three-month period a number of shares that does not exceed the greater of one percent of the number of shares of common stock then outstanding, which will equal approximately 267,521 shares immediately upon completion of this offering, or the average weekly trading volume of our common stock on the New York Stock Exchange during the four calendar weeks preceding the filing of a notice on Form 144 reporting the sale. Sales under Rule 144 are also restricted by manner of sale provisions, notice requirements and the availability of current public information about us. Rule 144 also provides that our affiliates who are selling shares of our common stock that are not restricted shares must comply with the same restrictions applicable to restricted shares with the exception of the one-year holding period requirement.

Under Rule 144(k), a person who is not deemed to have been our affiliate at any time during the three months preceding a sale, and who has beneficially owned the shares proposed to be sold for at least two years, including the holding period of any prior owner that is not an affiliate of ours, is entitled to sell those shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144. Accordingly, unless otherwise restricted, any such shares may be sold upon the expiration of the lock-up period described below.

Shares issued in reliance on Rule 701, such as the shares of common stock acquired upon the exercise of options or pursuant to other rights granted under our equity incentive plans, are also restricted, and may be resold, to the extent not restricted by the terms of the lock-up agreements by non-affiliates beginning 90 days after the date of this prospectus, subject only to the manner of sale provisions of Rule 144, and by affiliates under Rule 144, without compliance with its one-year minimum holding period. Of the total shares issuable upon exercise of vested options, 465,010 are subject to 180-day lock-up agreements.

Table of Contents

Additional Registration Statements

Equity Incentive Plans

We intend to file one or more registration statements under the Securities Act after the offering to register up to 4.3 million shares of our common stock underlying outstanding stock options or reserved for issuance under our equity incentive plans. These registration statements will become effective upon filing, and shares covered by these registration statements will be eligible for sale in the public market immediately after the effective dates of these registration statements, subject to the lock-up agreements described below.

Effects of Sales of Shares

Prior to this offering, there has been no public market for shares of our common stock. We cannot predict what effect, if any, that sales of shares of our common stock from time to time, or the availability of shares of our common stock for future sale, may have on the price for shares of our common stock. Sales of substantial amounts of common stock, or the perception that such sales could occur, could adversely affect prevailing prices for our common stock and could impair our future ability to obtain capital through an offering of equity securities.

Table of Contents

UNDERWRITING

The company, the selling stockholders and the underwriters named below have entered into an underwriting agreement with respect to the shares being offered. Subject to certain conditions, each underwriter has severally agreed to purchase the number of shares indicated in the following table. Goldman, Sachs & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated are the representatives of the underwriters.

Underwriters	**Number of Shares**
Goldman, Sachs & Co.	
Merrill Lynch, Pierce, Fenner & Smith Incorporated	
Lehman Brothers Inc.	
Banc of America Securities LLC	
Piper Jaffray & Co.	
Total	11,500,000

The underwriters are committed to take and pay for all of the shares being offered, if any are taken, other than the shares covered by the option described below unless and until this option is exercised.

If the underwriters sell more shares than the total number set forth in the table above, the underwriters have an option to buy up to an additional 1,725,000 shares from the selling stockholders to cover such sales. They may exercise that option for 30 days. If any shares are purchased pursuant to this option, the underwriters will severally purchase shares in approximately the same proportion as set forth in the table above.

The following tables show the per share and total underwriting discounts and commissions to be paid to the underwriters by the company and the selling shareholders. Such amounts are shown assuming both no exercise and full exercise of the underwriters option to purchase additional shares.

Paid by the Company	**No Exercise**	**Full Exercise**
Per Share	$	$
Total	$	$

Paid by the Selling Stockholders	**No Exercise**	**Full Exercise**
Per Share	$	$
Total	$	$

Shares sold by the underwriters to the public will initially be offered at the initial public offering price set forth on the cover of this prospectus. Any shares sold by the underwriters to securities dealers may be sold at a discount of up to $ per share from the initial public offering price. If all the shares are not sold at the initial public offering price, the representatives may change the offering price and the other selling terms.

The company and its officers, directors, and holders of substantially all of the company s common stock, including the selling stockholders, have agreed with the underwriters, subject to certain exceptions, not to dispose of or hedge any of their common stock or securities convertible into or exchangeable for shares of common stock during the period from the date of this prospectus continuing through the date 180 days after the date of this prospectus, except with the prior written consent of the representatives. This agreement does not apply to any existing employee benefit plans. See Shares Available for Future Sale for a discussion of certain transfer restrictions.

105

Table of Contents

The 180-day restricted period described in the preceding paragraph will be automatically extended if: (1) during the last 17 days of the 180-day restricted period the company issues an earnings release or announces material news or a material event; or (2) prior to the expiration of the 180-day restricted period, the company announces that it will release earnings results during the 15-day period following the last day of the 180-day period, in which case the restrictions described in the preceding paragraph will continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or announcement of the material news or material event.

Prior to the offering, there has been no public market for the shares. The initial public offering price has been negotiated among the company and the representatives. Among the factors to be considered in determining the initial public offering price of the shares, in addition to prevailing market conditions, will be the company s historical performance, estimates of the business potential and earnings prospects of the company, an assessment of the company s management and the consideration of the above factors in relation to market valuation of companies in related businesses.

An application will be made to list the common stock on the New York Stock Exchange under the symbol LL. In order to meet one of the requirements for listing the common stock on the New York Stock Exchange, the underwriters have undertaken to sell lots of 100 or more shares to a minimum of 2,000 beneficial holders.

In connection with the offering, the underwriters may purchase and sell shares of common stock in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. Covered short sales are sales made in an amount not greater than the underwriters option to purchase additional shares from the selling stockholders in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase additional shares pursuant to the option granted to them. Naked short sales are any sales in excess of such option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of various bids for or purchases of common stock made by the underwriters in the open market prior to the completion of the offering.

The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representatives have repurchased shares sold by or for the account of such underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions, as well as other purchases by the underwriters for their own accounts, may have the effect of preventing or retarding a decline in the market price of the company s stock, and together with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of the common stock. As a result, the price of the common stock may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued at any time. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), each underwriter has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date) it has not made and will not make an offer of shares to the public in that Relevant Member State prior to the publication of a prospectus in relation to the shares which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive, except that it may, with effect from and including the Relevant Implementation Date, make an offer of shares to the public in that Relevant Member State at any time:

(a) to legal entities which are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;

(b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in its last annual or consolidated accounts;

(c) to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives for any such offer; or

(d) in any other circumstances which do not require the publication by the company of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an offer of shares to the public in relation to any shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the shares to be offered so as to enable an investor to decide to purchase or subscribe the shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

Each underwriter has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000 (the FSMA)) received by it in connection with the issue or sale of the shares in circumstances in which Section 21(1) of the FSMA would not, if the company was not an authorized person, apply to the company; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the shares in, from or otherwise involving the United Kingdom.

The shares may not be offered or sold by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), or (ii) to professional investors within the meaning of the Securities and Futures Ordinance (Cap.571, Laws of Hong Kong) and any rules made thereunder or (iii) in other circumstances which do not result in the document being a prospectus within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), and no advertisement, invitation or document relating to the shares may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to shares which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.

Table of Contents

This prospectus has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the shares may not be circulated or distributed, nor may the shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the SFA), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the shares are subscribed or purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investor) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries rights and interest in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the shares under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA; (2) where no consideration is given for the transfer; or (3) by operation of law.

The securities have not been and will not be registered under the Securities and Exchange Law of Japan (the Securities and Exchange Law) and each underwriter has agreed that it will not offer or sell any securities, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

The underwriters do not expect sales to discretionary accounts to exceed five percent of the total number of shares offered.

The company and the selling stockholders estimate that their share of the total expenses of the offering, excluding underwriting discounts and commissions, will be approximately $2.5 million.

The company and the selling stockholders will agree to indemnify the several underwriters against certain liabilities, including liabilities under the Securities Act of 1933.

Certain of the underwriters and their respective affiliates have, from time to time, performed, and may in the future perform, various financial advisory and investment banking services for the company, for which they received or will receive customary fees and expenses. An affiliate of Banc of America Securities LLC is the lender under our new revolving credit agreement and the term-loan portion of our senior secured loan agreement.

Table of Contents

VALIDITY OF THE COMMON STOCK

The validity of the common stock offered hereby will be passed upon for us by Cleary Gottlieb Steen & Hamilton LLP, New York, New York, and for the underwriters by Sullivan & Cromwell LLP, New York, New York.

EXPERTS

The financial statements of Lumber Liquidators, Inc. at December 31, 2006 and 2005, and for each of the three years in the period ended December 31, 2006, appearing in this Prospectus and Registration Statement have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon appearing elsewhere herein, and are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form S-1 under the Securities Act of 1933 registering the common stock to be sold in this offering. As permitted by the rules and regulations of the SEC, this prospectus does not contain all of the information included in the registration statement and the exhibits and schedules filed as a part of the registration statement. For more information concerning us and the common stock to be sold in this offering, you should refer to the registration statement and to the exhibits and schedules filed as part of the registration statement.

The registration statement, including the exhibits and schedules filed as a part of the registration statement, may be inspected at the public reference room of the SEC at 100 F Street, N.E., Room 1580, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at http://www.sec.gov.

As a result of the filing of the registration statement, we will become subject to the information and reporting requirements of the Securities Exchange Act of 1934, and will file periodic proxy statements and will make available to our stockholders annual reports containing audited financial information for each year and quarterly reports for the first three quarters of each year containing unaudited interim financial information.

Table of Contents

Lumber Liquidators, Inc.

INDEX TO FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors

Lumber Liquidators, Inc.

We have audited the accompanying balance sheets of Lumber Liquidators, Inc. as of December 31, 2006 and 2005, and the related statements of income, stockholder s equity (deficit), and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lumber Liquidators, Inc. at December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, effective January 1, 2006, Lumber Liquidators, Inc. adopted Financial Accounting Standards Board Statement No. 123(R), Share-Based Payment, applying the prospective-transition method.

/s/ Ernst & Young LLP

Richmond, Virginia

March 26, 2007

Table of Contents

Lumber Liquidators, Inc.

Balance Sheets

(in thousands, except share data)

	December 31, 2006	December 31, 2005
Assets		
Current Assets:		
Cash and Cash Equivalents	$ 3,965	$ 6,031
Merchandise Inventories	51,758	30,009
Prepaid Expenses	3,638	1,984
Other Current Assets	3,359	2,644
Total Current Assets	**62,720**	**40,668**
Property and Equipment, net	9,332	9,515
Deferred Income Taxes	3,737	2,819
Other Assets	2,231	2,160
Total Assets	**$ 78,020**	**$ 55,162**
Liabilities and Stockholder s Equity (Deficit)		
Current Liabilities:		
Accounts Payable	$ 16,296	$ 8,412
Customer Deposits and Store Credits	6,804	7,360
Accrued Compensation	1,566	1,041
Other Current Liabilities	5,292	3,928
Current Portion of Long-Term Debt	2,804	2,450
Current Portion of Capital Lease Obligations	261	418
Total Current Liabilities	**33,023**	**23,609**
Long-Term Debt	6,479	7,194
Capital Lease Obligations	59	298
Stock Compensation Liability	9,132	8,092
Redeemable Preferred Stock	34,795	34,744
Stockholder s Equity (Deficit):		
Common Stock (No par value; authorized: 35,000,000 and 24,500,000 shares at December 31, 2006 and 2005, respectively; issued and outstanding: 15,000,100 at December 31, 2006 and 2005)		
Additional Capital	1,250	841
Retained Earnings (Deficit)	(6,718)	(19,616)
Total Stockholder s Equity (Deficit)	**(5,468)**	**(18,775)**
Total Liabilities and Stockholder s Equity (Deficit)	**$ 78,020**	**$ 55,162**

See accompanying notes to financial statements

Table of Contents

Lumber Liquidators, Inc.

Statements of Income

(in thousands, except share data and per share amounts)

	Year Ended December 31, 2006	2005	2004
Net Sales	**$ 332,060**	**$ 244,947**	**$ 171,766**
Cost of Sales	221,931	158,844	115,857
Gross Profit	**110,129**	**86,103**	**55,909**
Operating Expenses:			
Selling, General and Administrative Expenses	88,716	67,900	48,461
Impairment Loss on Long-Lived Assets			293
Total Operating Expenses	**88,716**	**67,900**	**48,754**
Operating Income	**21,413**	**18,203**	**7,155**
Interest Expense	722	638	429
Other (Income) Expense	(368)	(96)	190
Income Before Income Taxes	**21,059**	**17,661**	**6,536**
Provision for Income Taxes	8,161	6,948	(1,450)
Net Income	**$ 12,898**	**$ 10,713**	**$ 7,986**
Net Income per Common Share Basic	**$ 0.86**	**$ 0.71**	**$ 0.53**
Net Income per Common Share Diluted	**$ 0.56**	**$ 0.46**	**$ 0.51**
Weighted Average Common Shares Outstanding:			
Basic	15,000,100	15,000,100	15,000,100
Diluted	22,989,403	23,063,174	15,675,477

See accompanying notes to financial statements

F-4

Table of Contents

Lumber Liquidators, Inc.

Statements of Stockholder s Equity (Deficit)

(in thousands, except share data)

	Common Stock Shares	Common Stock Par Value	Additional Capital	Retained Earnings (Deficit)	Total Stockholder s Equity (Deficit)
Balance December 31, 2003	**100**	**$**	**$ 1**	**$ 3,619**	**$ 3,620**
Common Stock Dividend	15,000,000				
Distributions to Founder, net				(41,934)	(41,934)
Stock-Based Compensation Expense			86		86
Net Income				7,986	7,986
Balance December 31, 2004	**15,000,100**	**$**	**$ 87**	**$ (30,329)**	**$ (30,242)**
Contributions from Founder, net			581		581
Stock-Based Compensation Expense			173		173
Net Income				10,713	10,713
Balance December 31, 2005	**15,000,100**	**$**	**$ 841**	**$ (19,616)**	**$ (18,775)**
Stock-Based Compensation Expense			409		409
Net Income				12,898	12,898
Balance December 31, 2006	**15,000,100**	**$**	**$ 1,250**	**$ (6,718)**	**$ (5,468)**

See accompanying notes to financial statements

F-5

Table of Contents

Lumber Liquidators, Inc.

Statements of Cash Flows

(in thousands)

	Year Ended December 31, 2006	2005	2004
Cash Flows from Operating Activities:			
Net Income	$ 12,898	$ 10,713	$ 7,986
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Depreciation and Amortization	2,908	2,240	1,157
Deferred Income Taxes	(697)	(1,732)	(1,695)
Stock-Based Compensation Expense	1,449	3,306	3,024
Accretion of Redeemable Preferred Stock	51	51	
Impairment Loss on Long-Lived Assets			293
Changes in Operating Assets and Liabilities:			
Merchandise Inventories	(21,749)	(7,502)	(7,597)
Accounts Payable	7,884	(1,261)	2,308
Customer Deposits and Store Credits	(556)	2,245	1,387
Prepaid Expenses and Other Current Assets	(2,590)	(2,026)	(1,230)
Other Assets and Liabilities	1,812	1,954	499
Net Cash Provided by Operating Activities	**1,410**	**7,988**	**6,132**
Cash Flows from Investing Activities:			
Purchases of Property and Equipment	(2,719)	(4,327)	(6,547)
Purchase of Hardwood Holdings, LLC			(1,050)
Net Cash Used in Investing Activities	**(2,719)**	**(4,327)**	**(7,597)**
Cash Flows from Financing Activities:			
Proceeds from Long-Term Borrowings and Revolving Line	1,464	2,140	11,930
Repayments of Long-Term Debt	(1,825)	(3,009)	(1,609)
Principal Payments on Capital Lease Obligations	(396)	(500)	(979)
Proceeds from Sale of Redeemable Preferred Stock			35,000
Contributions from (Distributions to) Founder		708	(42,612)
Redeemable Preferred Stock Issuance Costs			(307)
Net Cash (Used In) Provided by Financing Activities	**(757)**	**(661)**	**1,423**
Net (Decrease) Increase in Cash and Cash Equivalents	(2,066)	3,000	(42)
Cash and Cash Equivalents, Beginning of Year	6,031	3,031	3,073
Cash and Cash Equivalents, End of Year	**$ 3,965**	**$ 6,031**	**$ 3,031**

See accompanying notes to financial statements

F-6

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements

(amounts in thousands, except share data and per share amounts)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Nature of Business

Lumber Liquidators, Inc. (the Company) is a multi-channel specialty retailer of hardwood flooring, and hardwood flooring enhancements and accessories, operating as a single business segment. The Company offers an extensive assortment of exotic and domestic hardwood species, engineered hardwoods, and laminates direct to the consumer. The Company also features the renewable flooring products bamboo and cork, and provides a wide selection of flooring enhancements and accessories, including moldings, noise-reducing underlay and adhesives. These products are primarily sold under the Company s private label brands, including the premium Bellawood floors. The Company sells primarily to homeowners or to contractors on behalf of homeowners through a network of stores located in primary or secondary metropolitan areas throughout the United States. In addition to the store locations, the Company s products may be ordered, and customer questions/concerns addressed, through both our call center in Toano, Virginia, and our website, LumberLiquidators.com. The Company finishes the majority of the Bellawood products in Toano, Virginia, which along with the call center, corporate offices and distribution facility represent the Corporate Headquarters.

Organization and Basis of Financial Statement Presentation

The Company was organized in 1994 as a Massachusetts corporation. The original equity interest was held solely by the founder and current chairman of the Board (the Founder). Initially, the Company elected to be taxed as a subchapter S corporation and the Founder was responsible for federal and most state tax payments. On December 1, 2004, Restated Articles of Organization were adopted, and the Company authorized 3,000,000 shares of Series A Convertible Preferred Stock (the Redeemable Preferred Stock), par value $.01, increased the authorized number of shares of common stock, no par value, from 15,000 to 24,500,000, and changed to C corporation tax status. Effective October 18, 2006, the number of authorized shares of common stock was increased to 35,000,000.

Use of Estimates

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

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity date of three months or less when purchased to be cash equivalents. The Company accepts a range of debit and credit cards, and these transactions are transmitted to a bank for reimbursement within 24 hours, except for Friday and Saturday transactions, which are transmitted on Monday. The payments due from the banks for these debit and credit card transactions are generally received, or settle, within 24-48 hours of the transmission date. The Company considers all debit and credit card transactions that settle in less than seven days to be cash and cash equivalents. Amounts due from the banks for these transactions classified as cash and cash equivalents totaled $2,791 and $2,151 at December 31, 2006 and 2005, respectively.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

Fair Value of Financial Instruments

The carrying amounts of financial instruments such as cash and cash equivalents, notes receivable, accounts payable, and other liabilities approximate fair value because of the short-term nature of these items. The carrying amounts of the equipment financing obligations and long-term debt approximate fair value because the interest rates on these instruments change with, or approximate, market interest rates.

Merchandise Inventories

The Company values merchandise inventories at the lower of cost or market. Merchandise cost is determined using the average cost method. All of the hardwood flooring purchased from vendors is either prefinished or unfinished, and in immediate saleable form. The Company adds the finish to, and boxes, various species of unfinished product, to produce certain proprietary products, primarily Bellawood, at its finishing facility. These finishing and boxing costs are included in the average unit cost of related merchandise inventory. The Company maintains an inventory reserve for loss or obsolescence, based on historical results and current sales trends. This reserve was $674 and $539 at December 31, 2006 and 2005, respectively.

Impairment of Long-Lived Assets

The Company evaluates potential impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets may be impaired, and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets. If impairment exists and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets, an impairment loss is recorded based on the difference between the carrying value and fair value of the assets. During 2004, the Company relocated its Corporate Headquarters and recorded an impairment charge of $293, primarily representing the remaining net asset value of the finishing equipment and leasehold improvements idled at the previous facility.

Goodwill

In 2004, the Company acquired the remaining 50% of the stock of its subsidiary, Hardwood Holdings LLC, for a cash payment of $1,050 and the forgiveness of amounts owed to the Company. The amount of the purchase price in excess of the carrying value of the minority interest liability of $1,050 was recorded as goodwill and is included within other assets. The Company evaluates goodwill for impairment on an annual basis, or whenever events or changes in circumstance indicate that the carrying value may be impaired. Based on the analysis performed, the Company has concluded that no impairment in the value of goodwill has occurred.

Recognition of Net Sales

The Company recognizes net sales for products purchased at the time the customer takes possession of the merchandise. Service revenue, primarily freight charges for in-home delivery, is recognized when the service has been rendered. Net sales are reduced by an allowance for anticipated sales returns based on historical and current sales trends and experience. The sales returns allowance and related changes were not significant for 2006, 2005 or 2004.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

The Company generally requires customers to pay a deposit, equal to approximately 50% of the retail sales value, when purchasing merchandise inventories not regularly carried in a given store location, or not currently in stock. These deposits are included in Customer Deposits and Store Credits until the customer takes possession of the merchandise.

Cost of Sales

The cost of sales includes the actual cost of the merchandise sold, the transportation costs from vendor to the Company s distribution center or store location, any applicable finishing costs related to production of the Company s proprietary brand, the transportation costs from the distribution center to the store locations, and any inventory adjustments, including shrinkage.

The Company includes transportation costs for the delivery of products directly from stores to customers in cost of sales if delivered by third parties or in selling, general and administrative expenses (or SG&A) if delivered by the Company s delivery fleet. Costs related to the Company s delivery fleet, which include delivery salaries, maintenance and depreciation, totaled approximately $1,500 in 2006 and $2,400 for both 2005 and 2004.

The Company offers a range of prefinished products with warranties on the durability of the finish ranging from 10 to 50 years. Warranty reserves are based primarily on claims experience, sales history and other considerations, and warranty costs are recorded in the cost of sales. Warranty costs and changes to the warranty reserve were not significant for the years 2006, 2005 or 2004.

Advertising Costs

Advertising costs charged to SG&A were $36,288, $27,570 and $20,121 in 2006, 2005 and 2004, respectively. The Company uses various types of media to brand its name and advertise its products. Media production costs are generally expensed as incurred, except for direct mail, which is expensed when the finished piece enters the postal system. Media placement costs are generally expensed in the month the advertising occurs, except for contracted endorsements and sports agreements, which are generally expensed ratably over the contract period. Amounts paid in advance under endorsement contracts are included in prepaid expenses, and totaled $2,667 and $1,021 at December 31, 2006 and 2005, respectively.

Store Opening Costs

Costs to open new store locations are charged to SG&A as incurred.

Depreciation and Amortization

Property and equipment is carried at cost and depreciated on the straight-line method over the estimated useful lives of the related assets. Vehicles and office equipment are depreciated over useful lives which range from three to five years, and finishing equipment is depreciated over five years. The estimated useful lives for leasehold improvements are the shorter of the estimated useful lives or the remainder of the lease terms. For leases with optional renewal periods, the Company uses the original lease term, excluding optional renewal periods to determine the appropriate estimated useful lives. Leasehold improvements are currently being amortized over useful lives which range from two to fifteen years.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

Some of the Company s vehicles and finishing equipment are leased under capital leases. These assets are recorded at the lower of fair value or the present value of net minimum lease payments and amortized over the shorter of their estimated useful life or the life of the lease. Amortization of capital leases is included within depreciation expense.

Operating Leases

The Company has operating leases for its stores, Corporate Headquarters and certain transportation equipment. The lease agreements for certain stores contain rent escalation clauses and rent holidays. For scheduled rent escalation clauses during the lease terms or for rental payments commencing at a date other than the date of initial occupancy, the Company records minimum rental expenses on a straight-line basis over the terms of the leases in SG&A.

Stock-Based Compensation

The Company adopted the provisions of Statement of Financial Accounting Standards (or SFAS) No. 123 (revised in 2004), Share-Based Payment (or SFAS 123 (R)), using the prospective-transition method effective January 1, 2006. Prior to the adoption of SFAS 123 (R), the Company used the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25 (or APB 25). There were no material differences in the calculations of the Company s stock-based compensation expense under APB 25 and SFAS 123, Accounting for Stock-Based Compensation in 2005 or 2004.

The Company maintains several equity incentive plans under which it may grant non-qualified stock options and incentive stock options to employees and non-employee directors. The Company recognizes expense for its stock-based compensation based on the fair value of the awards that are granted. Measured compensation cost is recognized ratably over the requisite service period of the related stock-based compensation award.

The fair value of stock options was estimated at the date of grant using the Black-Scholes-Merton valuation model. In order to determine the related stock compensation expense, the Company used the following assumptions:

Expected life of 7.5 years.

Expected stock price volatility of 35%, based on the median volatility of companies in a peer group.

Risk free interest rates from 4.6% to 5.2%.

Dividends are not expected to be paid in any year.

Stock-based compensation awards that may be settled in cash are accounted for as liabilities and recorded at intrinsic value as prescribed in SFAS 123 (R).

Income Taxes

Income taxes are accounted for in accordance with SFAS No. 109, Accounting for Income Taxes (or SFAS 109). Income taxes are provided for under the asset and liability method and consider differences between the tax and financial accounting bases. The tax effects of these differences are

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

reflected on the balance sheet as deferred income taxes and valued using the effective tax rate expected to be in effect when the differences reverse. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion of the deferred tax asset will not be realized. In evaluating the need for a valuation allowance, the Company took into account various factors, including the expected level of future taxable income. If actual results differ from the assumptions made in the evaluation of the valuation allowance, a change in the valuation allowance will be recorded through income tax expense in the period such determination is made.

In December 2004, the Company became a C corporation and income taxes have been provided since that date. The effect of initially recognizing deferred tax assets and liabilities related to this change in tax status was included in the provision for income taxes (benefit) for the year ended December 31, 2004.

Net Income per Common Share

Basic net income per common share is determined by dividing net income by the weighted average number of common shares outstanding during the year. Diluted net income per common share is determined by dividing net income by the weighted average number of common shares outstanding during the year, plus the dilutive effect of common share equivalents, such as stock options, warrants and preferred stock. Common shares and common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options and warrants and the conversion of redeemable convertible preferred stock, except when the effect of their inclusion would be antidilutive.

Reclassifications

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

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (or FASB) issued FASB Interpretation No. 48 (or FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of January 1, 2007. The adoption of FIN 48 did not have a material effect on the Company s financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (or SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (or SFAS 159). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (or fair value option) and to report in earnings unrealized gains and losses on those items for which the fair value option has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for the Company as of the first quarter of 2008. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

NOTE 2. NOTES RECEIVABLE

The Company has notes receivable from two key merchandise suppliers (together, the Vendor Notes) included in other assets on the balance sheets. One of the Vendor Notes, executed August 23, 2005 (the 2005 Note), consolidated several advances existing at that date, and matures in August 2009. The 2005 Note had an outstanding balance due to the Company of $701 and $880 at December 31, 2006 and 2005, respectively, of which $209 and $180, respectively, have been included in other current assets on the balance sheets. On August 15, 2006, the Company established two additional Vendor Notes with an original aggregate value of $1,265 (the 2006 Notes), maturing in February 2008. At December 31, 2006, the 2006 Notes had an outstanding balance due to the Company of $1,079, of which $800 has been included in other current assets.

NOTE 3. PROPERTY AND EQUIPMENT

Property and equipment consisted of:

	December 31,	
	2006	**2005**
Vehicles	$ 7,633	$ 7,317
Finishing Equipment	3,151	3,097
Office Equipment	3,053	1,807
Store Fixtures	991	500
Leasehold Improvements	817	298
	15,645	13,019
Less: Accumulated Depreciation and Amortization	6,313	3,504
Property and Equipment, net	$ 9,332	$ 9,515

As of December 31, 2006 and 2005, property and equipment, net included assets under capital leases of $339 and $578, respectively, net of accumulated amortization of $1,410 and $1,171, respectively.

F-12

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

NOTE 4. LONG-TERM DEBT
Long-term debt consisted of the following:

	December 31, 2006	December 31, 2005
Consolidated Term Note	$ 8,398	$
Revolving Line of Credit	745	
Term Loan		4,000
Equipment Line of Credit		5,411
Other Notes Payable	140	233
	9,283	9,644
Less: Current Portions of Long-Term Debt	2,804	2,450
Total Long-Term Debt	$ 6,479	$ 7,194

On March 23, 2006, the Company entered into a loan agreement (the 2006 Loan Agreement) which consolidated the then existing term loan and equipment line of credit into one, $9,881 consolidated term note (the Consolidated Term Note) and provided a $5,000 revolving line of credit (the Revolver). Availability under the Revolver was increased to $10,000 on July 31, 2006. The 2006 Loan Agreement is secured by the Company s inventory and bears interest, payable monthly in arrears, at a variable rate, adjusted annually, based on the Company s performance under certain specified operating ratios. From inception to December 31, 2006, the 2006 Loan Agreement bore interest at the 30-Day London Interbank Offered Rate (LIBOR) + 0.90%. The 2006 Loan Agreement includes certain financial covenants that, among other things, require the Company to meet certain defined financial ratios, on a quarterly basis. The Company is in compliance with these financial covenants at December 31, 2006.

The Consolidated Term Note requires 60 equal, monthly principal payments, which began April 1, 2006 and conclude on March 1, 2011. The Revolver has no mandated payment provisions and expires on May 31, 2008. The Revolver has no restrictions on the mix of borrowings to letters of credit, other than the aggregate limit of $10,000. The Company primarily uses draws on the Revolver and letters of credit to fund international inventory purchases and has classified the entire balance as current at December 31, 2006. The Company had outstanding commitments under letters of credit of $2,018 at December 31, 2006. At December 31, 2006, $7,237 was available to borrow under the Revolver. The Company pays a fee of 0.25% per annum on any unused portion of the Revolver.

Prior to the 2006 Loan Agreement, the Company had a term loan, an equipment line of credit and a $5,000 revolving facility under an agreement executed in April 2004 (the 2004 Loan Agreement). The 2004 Loan Agreement also bore variable interest dependent on the Company s performance under certain defined financial ratios and at December 31, 2005, bore interest at LIBOR plus 1.25%. Interest rates under the 2004 Loan Agreement were generally higher in 2004 in comparison to 2005 and 2006, with the term loan and equipment line of credit bearing interest of LIBOR plus 1.50% at December 31, 2004.

Interest payments totaled $672, $574 and $417 in 2006, 2005 and 2004, respectively.

F-13

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

At December 31, 2006, scheduled maturities of long-term debt were: $2,804 in 2007; $2,033 in 2008; $1,976 in 2009; $1,976 in 2010; and $494 in 2011.

The Company believes the carrying amount of the long-term debt approximates fair value as the stated, variable interest rates approximate market rates.

NOTE 5. REDEEMABLE PREFERRED STOCK

In December 2004, a private investment group (the Investors) purchased 7,952,018 shares of Redeemable Preferred Stock for $35,000, or approximately $4.40 per share (the Preferred Sale). In conjunction with the sale of the Redeemable Preferred Stock, a 150,000 to 1 common stock dividend was declared and distributed to the Founder. Of the proceeds received from the sale of the Redeemable Preferred Stock, the Company retained $5,000 for general working capital purposes and $30,000 was paid to the Founder in the form of a cash distribution. To complete the Preferred Sale, the Company incurred and capitalized costs of $307, which are ratably accreted to interest through December 2010.

On or after December 6, 2010, any or all holders of the Redeemable Preferred Stock may elect to have the Company redeem the shares at $4.40 per share, plus any dividends declared but unpaid at the time of redemption. The Company cannot redeem shares of the Redeemable Preferred Stock at its discretion. At any time after December 6, 2004, either by election of an individual holder, or upon the holders of two-thirds of all the Redeemable Preferred Stock electing conversion, a share of Redeemable Preferred Stock is convertible, without additional consideration, into one share of common stock. Each share of Redeemable Preferred Stock has voting rights equivalent to a share of common stock, and any dividends declared must be distributed ratably among Common and Redeemable Preferred Stock, and the Investors are protected from dilution by certain defined provisions. Until redeemed or converted, the Redeemable Preferred Shares do not accrue any additional benefit.

NOTE 6. LEASES

The Company leases all store locations, the Corporate Headquarters and certain transportation equipment. The store location leases are operating leases and generally have five-year base periods with multiple five-year renewal periods.

The Founder is also the sole owner of ANO LLC, DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and he has a 50% membership interest in BMT Holdings, LLC (collectively, ANO and Related Companies). The Company leased 26, 23 and 13 of its locations from ANO and Related Companies at December 31, 2006, 2005 and 2004 representing 28.6%, 30.3% and 22.8% of total store leases, respectively. The Company leases the Corporate Headquarters from ANO LLC under an operating lease with a base period through December 31, 2019.

Rental expense for 2006, 2005 and 2004 was $5,213, $4,425 and $2,347, respectively, with rental expense attributable to ANO and Related Companies of $2,261, $2,110 and $1,068, respectively.

F-14

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

The future minimum rental payments under capital leases and non-cancellable operating leases, segregating ANO and Related Companies leases from all other operating leases, were as follows at December 31, 2006:

		Operating Leases				
		ANO and Related Companies				Total
	Capital					Operating
	Leases	Store Leases	Headquarters Lease	Other Leases		Leases
2007	$ 269	$ 1,189	$ 974	$ 3,385		$ 5,548
2008	60	1,094	1,003	3,139		5,236
2009	1	698	1,033	2,496		4,227
2010		474	1,064	1,819		3,357
2011		121	1,096	957		2,174
Thereafter			10,040	802		10,842
Total minimum lease payments	330	$ 3,576	$ 15,210	$ 12,598		$ 31,384
Less: amounts representing interest costs	(10)					
Present value of minimum lease payments	320					
Less: current maturities	(261)					
Long-term capital lease obligations	$ 59					

NOTE 7. STOCK BASED COMPENSATION

Total stock-based compensation expense was $1,449, $3,306 and $3,024 for 2006, 2005 and 2004, respectively. The Company maintains:

i) a stock option plan for executive management, the 2004 Stock Option and Grant Plan, as amended October 18, 2006 (the 2004 Option Plan),

ii) a stock option plan for non-employee members of the Board, the 2006 Equity Plan for Non-Employee Directors, as amended October 18, 2006 (the 2006 Director Plan), and

iii) a stock unit plan for regional store management, the 2006 Stock Unit Plan for Regional Managers (the 2006 Regional Plan).

The Company has reserved a total of 2.3 million shares of common stock to provide for the exercise of options under the 2004 Option Plan and the 2006 Director Plan. Under the 2006 Regional Plan, 85,000 stock units are outstanding and no additional grants are available.

The Company is also a party to a stock-based agreement between the Founder and his brother, Kevin Sullivan, a regional manager (or Kevin), accounted for as a variable performance plan (the Variable Plan). The Variable Plan was established in 1998, and modified in August 2005. In addition, the Company had a stock warrant plan (the Warrant Plan), established in 2004, with a senior executive who separated from the Company in May 2006 (the Former Executive).

In 2006, the Company granted the first stock options under the 2004 Option Plan. 952,691 stock options were granted in July (the July Grant) and 765,000 stock options were granted in October (the

F-15

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

October Grant). The stock options granted in July 2006 carry an exercise price of $7.58, the fair value of the Company on a fully diluted per share basis, and vest over a four year period, except in the event of the Company s initial public offering (the IPO), in which case the vesting is accelerated by one year. The stock options granted in October 2006 carry an exercise price of $7.83, the fair value of the Company on a fully diluted per share basis, vest over a four year period, but generally do not have vesting acceleration due to the IPO. The stock options under the 2004 Option Plan expire 10 years from the grant date. The fair value of the July Grant and October Grant were determined to be $3.74 and $3.75 per option, respectively, and stock-based compensation expense for these grants totaled $631 in 2006. As of December 31, 2006, the intrinsic value of these options totaled $3,303 and the weighted average remaining contractual term was 9.7 years.

In conjunction with the July Grant, the Company granted 79,156 stock options under the 2006 Director Plan. These stock options also carry an exercise price of $7.58, vest over a four year period, include a vesting acceleration for the IPO and expire 10 years from the grant date. Stock-based compensation expense for this grant totaled $37 in 2006. As of December 31, 2006, the intrinsic value of these options totaled $156 and the weighted average remaining contractual term was 9.5 years.

At December 31, 2006, no stock options were exercisable under either the 2004 Option Plan or the 2006 Director Plan.

The Founder will contribute the 85,000 shares of common stock necessary to provide for the exercise of the 85,000 stock units granted under the 2006 Regional Plan in July and outstanding at December 31, 2006. The stock units vest over a five year period, but expire without value unless the IPO or a sale event, as defined, occur prior to the mandatory redemption of the Redeemable Preferred Stock for cash at the Conversion Price. As such, the Company has not recorded compensation expense related to the 2006 Regional Plan as of December 31, 2006.

The Variable Plan, as modified in August 2005, awarded Kevin the right (the Variable Right) to a fixed ownership percentage of 2.5% on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria, primarily a comparison of the net income of the region under Kevin s management to total Company net income on a trailing twelve-month basis. The Variable Right is exercisable for shares of common stock, contributed by the Founder, in conjunction with the IPO or a sale event, as defined. On February 1, 2008, the Variable Plan allows for a cash settlement of the Variable Right at a defined, performance based, value through put-call provisions, which may be executed by either the Founder or Kevin. The Founder is liable for the cash payment, and the Company guarantees the performance. Immediately prior to the completion of the IPO or sale event, however, the Variable Right is considered exercised in full, and any cash settlement provisions via put-call rights terminate.

Prior to the August 2005 modification of the Variable Plan, share based compensation expense was recorded based on Kevin having earned a 5% ownership interest on a fully diluted basis, again based primarily on the performance of the region under his management.

The Company recorded stock-based compensation expense under the Variable Plan of $1,040, $3,133 and $2,938 in 2006, 2005 and 2004, respectively, and carried a long-term liability of $9,132 and $8,092 at December 31, 2006 and 2005, respectively.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

Under the Warrant Plan, the stock-based compensation expense of $173 and $86 in 2005 and 2004, respectively, was reversed in 2006 upon the Former Executive separating from the Company.

As of December 31, 2006 total unrecognized stock-based compensation expense related to nonvested stock options was approximately $6,060 and is expected to be recognized over a weighted average period of approximately 3.7 years.

NOTE 8. INCOME TAXES
The provision for income taxes consists of the following:

	Year Ended December 31,		
	2006	2005	2004
Current			
Federal	$ 7,433	$ 7,242	$
State	1,425	1,438	245
Total Current	8,858	8,680	245
Deferred			
Federal	(627)	(1,444)	(1,415)
State	(70)	(288)	(280)
Total Deferred	(697)	(1,732)	(1,695)
Total Provision for Income Taxes	$ 8,161	$ 6,948	$ (1,450)

The reconciliation of significant differences between income tax expense (benefit) applying the federal statutory rate of 35% and the actual income tax expense (benefit) at the effective rate are as follows:

	Year Ended December 31,		
	2006	2005	2004
Income tax expense at federal statutory rate	$ 7,299	$ 6,203	$ 2,291
Increases (decreases):			
State income taxes, net of federal income tax benefit	855	745	264
Effect of change in tax status			(3,994)
Other	7		(11)
Total	$ 8,161	$ 6,948	$ (1,450)

F-17

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

The tax effects of temporary differences that result in significant portions of the deferred tax accounts are as follows:

	December 31, 2006	December 31, 2005
Deferred Tax Liabilities:		
Prepaid Expenses	$ (290)	$
Depreciation and Amortization	(241)	(578)
Total Deferred Tax Liabilities	(531)	(578)
Deferred Tax Assets:		
Stock Compensation Expense	3,797	3,279
Reserves	677	608
Other	181	118
Total Deferred Tax Assets	4,655	4,005
Net Deferred Tax Asset	$ 4,124	$ 3,427

The Company made income tax payments of $6,989, $10,381 and $109 in 2006, 2005 and 2004, respectively.

NOTE 9. PROFIT SHARING PLAN

The Company maintains a profit-sharing plan, qualified under Section 401(k) of the Internal Revenue Code, for all eligible employees. Employees are eligible to participate following the completion of one year of service and attainment of age 21. The Company matches 50% of employee contributions up to 6% of eligible compensation. The Company s matching contributions, included in SG&A, totaled $160, $124 and $68 in 2006, 2005 and 2004, respectively.

NOTE 10. NET INCOME PER COMMON SHARE

The following table sets forth the computation of basic and diluted net income per common share:

	Year Ended December 31, 2006	2005	2004
Net Income	$ 12,898	$ 10,713	$ 7,986
Weighted Average Common Shares Outstanding Basic	15,000,100	15,000,100	15,000,100
Effect of Dilutive Securities:			

Redeemable Preferred Stock	7,952,018	7,952,018	675,377
Warrants	37,285	111,056	
Weighted Average Common Shares Outstanding Diluted	22,989,403	23,063,174	15,675,477
Net Income per Common Share Basic	$ 0.86	$ 0.71	$ 0.53
Net Income per Common Share Diluted	$ 0.56	$ 0.46	$ 0.51

The Company s calculation of diluted net income per common share in 2006 and 2005 included the dilutive impact of common stock warrants under the Warrant Plan. For 2006, options to purchase 1,796,847 shares of common stock were not included in the computation of Weighted Average Common Shares Outstanding Diluted because the effect would be antidilutive. There were no options outstanding prior to July 2006.

Table of Contents

Lumber Liquidators, Inc.

Notes to Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

NOTE 11. RELATED PARTY TRANSACTIONS

As described in Note 6, the Company leases a number of its store locations and Corporate Headquarters from ANO and Related Companies.

As of December 31, 2006, other assets included $35 that the Founder owed the Company in the normal course of business. The amount was paid in the first quarter of 2007.

In 2005 and pursuant to the terms of the Preferred Sale, the Founder assumed a net liability related to a capitalized lease, and the Company recorded a $581 contribution from the Founder.

In 2004, the Company distributed a net $41,934 to the Founder, including $11,934 of distributions primarily related to the Company s status as an S corporation and a $30,000 distribution related to the Preferred Sale.

NOTE 12. COMMITMENTS AND CONTINGENCIES

In July 2006, the Company entered into a purchase agreement with a vendor where the Company would purchase a total of approximately 27 million square feet of the vendor s assorted products over a four-year period, with the unit prices set at the time a purchase order is created/accepted.

Legal Proceedings

On January 4, 2007, Clifford Wayne Bassett and Clifford Wayne Bassett, MD, PC (together Dr. Bassett) filed a lawsuit entitled *Clifford Wayne Bassett et al. v. Lumber Liquidators, Inc. et al.*, in the U.S. District Court for the Southern District of New York, against the Company, E.W. Scripps Company (Scripps) and others. The Company purchased an article from Scripps describing the benefits of hardwood flooring in relation to other types of flooring. The article contained a quote by Dr. Basset, an allergist, who claims that the use of the quote was unauthorized. Dr. Basset has asserted damages in excess of $10 million. The matter is in the early stages of litigation and, while there is a reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss, if any, at this time. In connection with SFAS No. 5, Accounting for Contingencies (or SFAS 5) paragraph 8, we have not made any provision in connection with this matter. The Company intends to defend vigorously against this claim and, to the extent warranted, to seek contribution or indemnification from other parties.

The Company received a demand letter dated December 22, 2006, from counsel representing the Former Executive in connection with his resignation of employment on May 31, 2006. In the letter, counsel for the Former Executive requested that documents related to the executive be preserved. When he terminated his employment, the Former Executive asserted that he did so for good reason , as defined within his employment agreement and the Warrant Plan. Under the provisions of his employment agreement, his termination for good reason would entitle him to 2 years of wages and benefits, and under the provisions of the Warrant Plan, he would be entitled to 1% of the outstanding common stock. In June 2006, the Company responded to the Former Executive that his contention regarding his termination for good reason was erroneous. The Former Executive has not filed a lawsuit or a demand for arbitration. While there is a reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss, if any, at this time. In connection with SFAS 5 paragraph 8, we have not made any provision in connection with this matter. The Company intends to defend vigorously against any claim brought in connection with this matter.

F-19

Table of Contents

Lumber Liquidators, Inc.

Notes to the Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

The Company is from time to time subject to claims and disputes arising in the normal course of business. In the opinion of management, while the outcome of any such claims and disputes cannot be predicted with certainty, the ultimate liability of the Company in connection with these matters is not expected to have a material adverse effect on the Company s results of operations, financial position or cash flows.

Table of Contents

Lumber Liquidators, Inc.

Condensed Balance Sheets

(in thousands, except share data)

	June 30, 2007 (unaudited)	December 31, 2006
Assets		
Current Assets:		
Cash and Cash Equivalents	$ 5,553	$ 3,965
Merchandise Inventories	77,871	51,758
Prepaid Expenses	4,542	3,638
Other Current Assets	3,125	3,359
Total Current Assets	**91,091**	**62,720**
Property and Equipment, net	9,582	9,332
Deferred Income Taxes	5,325	3,737
Other Assets	2,544	2,231
Total Assets	**$ 108,542**	**$ 78,020**
Liabilities and Shareholder s Equity (Deficit)		
Current Liabilities:		
Accounts Payable	$ 26,883	$ 16,296
Customer Deposits and Store Credits	9,192	6,804
Stock Compensation Liability	12,184	
Accrued Compensation	2,327	1,566
Other Current Liabilities	8,635	5,292
Current Portion of Long-Term Debt	8,906	2,804
Current Portion of Capital Lease Obligations	148	261
Total Current Liabilities	**68,275**	**33,023**
Long-Term Debt	5,462	6,479
Capital Lease Obligations	18	59
Stock Compensation Liability		9,132
Redeemable Preferred Stock	34,821	34,795
Stockholder s Equity (Deficit):		
Common stock (No par value; authorized: 35,000,000; issued and outstanding: 15,000,100)		
Additional Capital	2,108	1,250
Retained Earnings (Deficit)	(2,142)	(6,718)
Total Stockholder s Equity (Deficit)	**(34)**	**(5,468)**
Total Liabilities and Stockholder s Equity	**$ 108,542**	**$ 78,020**

See accompanying notes to condensed financial statements

F-21

Table of Contents

Lumber Liquidators, Inc.

Condensed Statements of Income

(in thousands, except share data and per share amounts)

(unaudited)

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Net Sales	**$ 105,725**	**$ 88,078**	**$ 197,747**	**$ 164,129**
Cost of Sales	71,350	58,625	132,801	108,267
Gross Profit	**34,375**	**29,453**	**64,946**	**55,862**
Selling, General and Administrative Expenses	30,415	21,487	57,231	42,024
Operating Income	**3,960**	**7,966**	**7,715**	**13,838**
Interest Expense	182	171	356	338
Other (Income) Expense	(45)	(73)	(100)	(180)
Income Before Income Taxes	**3,823**	**7,868**	**7,459**	**13,680**
Provision for Income Taxes	1,478	3,049	2,883	5,301
Net Income	**$ 2,345**	**$ 4,819**	**$ 4,576**	**$ 8,379**
Net Income per Common Share Basic	**$ 0.16**	**$ 0.32**	**$ 0.31**	**$ 0.56**
Net Income per Common Share Diluted	**$ 0.10**	**$ 0.21**	**$ 0.20**	**$ 0.36**
Weighted Average Common Shares Outstanding:				
Basic	15,000,100	15,000,100	15,000,100	15,000,100
Diluted	23,103,493	23,015,510	23,027,806	23,026,463

See accompanying notes to condensed financial statements

F-22

Table of Contents

Lumber Liquidators, Inc.

Condensed Statements of Cash Flows

(unaudited)

	Six months ended June 30, 2007	Six months ended June 30, 2006
Cash Flows from Operating Activities:		
Net Income	$ 4,576	$ 8,379
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation and Amortization	1,671	1,359
Deferred Income Taxes	(1,588)	(182)
Stock-Based Compensation Expense	3,910	259
Accretion of Redeemable Preferred Stock	26	26
Changes in Operating Assets and Liabilities:		
Merchandise Inventories	(26,113)	(31,056)
Accounts Payable	10,587	15,174
Customer Deposits and Store Credits	2,388	468
Prepaid Expenses and Other Current Assets	(670)	1,307
Other Assets and Liabilities	3,852	631
Net Cash Used in Operating Activities	**(1,361)**	**(3,635)**
Cash Flows from Investing Activities:		
Purchases of Property and Equipment	(1,982)	(1,105)
Net Cash Used in Investing Activities	**(1,982)**	**(1,105)**
Cash Flows from Financing Activities:		
Proceeds from Long-Term Borrowings and Revolving Line	6,110	2,696
Repayments of Long-Term Borrowings and Revolving Line	(1,025)	(764)
Principle Payments on Capital Lease Obligations	(154)	(214)
Net Cash Provided by Financing Activities	**4,931**	**1,718**
Net Increase in Cash and Cash Equivalents	**1,588**	**(3,022)**
Cash and Cash Equivalents, Beginning of Period	**3,965**	**6,031**
Cash and Cash Equivalents, End of Period	**$ 5,553**	**$ 3,009**

See accompanying notes to condensed financial statements

F-23

Table of Contents

Lumber Liquidators, Inc.

Notes to Condensed Financial Statements

(amounts in thousands, except share data and per share amounts)

(unaudited)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Financial Statement Presentation

The unaudited condensed financial statements included in this quarterly report have been prepared by Lumber Liquidators, Inc. (Lumber Liquidators or the Company) according to the rules and regulations of the Securities and Exchange Commission (the SEC) and according to accounting principles generally accepted in the United States of America (or GAAP) for interim financial statements. The accompanying balance sheet information as of December 31, 2006 is derived from our audited financial statements. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted in accordance with the SEC s rules and regulations for interim financial statements. The financial statements reflect, in the opinion of management, all adjustments which consist solely of normal recurring adjustments necessary to present fairly the Company s financial position and results of operations as of and for the periods indicated.

The results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results of operations that may be achieved for the full year.

The unaudited condensed financial statements included in this quarterly report should be read in conjunction with the audited financial statements and related footnotes included in the Form S-1 filed with the SEC.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (or FASB) issued FASB Interpretation No. 48 (or FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 was effective as of January 1, 2007. The adoption of FIN 48 did not have a material effect on the Company s financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (or SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (or SFAS 159). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (or fair value option) and to report in earnings unrealized gains and losses on those items for which the fair value option has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for the

F-24

Table of Contents

Lumber Liquidators, Inc.

Notes to Condensed Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

(unaudited)

Company as of the first quarter of 2008. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

NOTE 2. NOTES RECEIVABLE

In June 2007, the Company consolidated the two outstanding notes receivable from merchandise suppliers (the 2006 Notes) into one note with an aggregate value of $912 (the 2007 Note), maturing in June 2010. A separate note (the 2005 Note), which matures in August 2009, was not modified. The 2007 Note and the 2005 Note (together, the Vendor Notes) had an outstanding balance due to the Company of $1,780, of which $1,009 had been included in other current assets as of December 31, 2006. As of June 30, 2007, the Vendor Notes had an outstanding balance of $1,480 due to the Company, of which $499 has been included in other current assets.

NOTE 3. LONG-TERM DEBT

Long-term debt consisted of the following:

	June 30, 2007	December 31, 2006
Consolidated Term Note	$ 7,410	$ 8,398
Revolving Line of Credit	6,855	745
Other Notes Payable	103	140
	14,368	9,283
Less: Current Portions of Long-Term Debt	8,906	2,804
Total Long-Term Debt	$ 5,462	$ 6,479

The Consolidated Term Note requires 60 equal, monthly principal payments, which began April 1, 2006 and conclude on March 1, 2011. The Loan Agreement is secured by the Company s inventory and bears interest, payable monthly in arrears, at a variable rate, adjusted annually, based on the Company s performance under certain specified operating ratios. From inception to June 30, 2007, the Loan Agreement bore interest at the 30-Day London Interbank Offered Rate (LIBOR) + 0.90%. The Loan Agreement includes certain financial covenants that, among other things, require the Company to meet certain defined financial ratios on a quarterly basis. The Company is in compliance with these financial covenants at June 30, 2007.

The Revolving Line of Credit (or 2006 Revolver) has no mandated payment provisions and was set to expire on May 31, 2008. The 2006 Revolver had no restrictions on the mix of borrowings to letters of credit, other than the aggregate limit of $10,000. The Company primarily uses draws on the Line of Credit and letters of credit to fund international inventory purchases and has classified the entire balance as current at June 30, 2007 and December 31, 2006. At June 30, 2007, the Company had no outstanding commitments under letters of credit and $3,145 was available to borrow under the Revolver. The 2006 Revolver bore interest at the 30-Day LIBOR + 0.90% as of June 30, 2007, and the Company pays a fee of 0.25% per annum on any unused portion of the Revolver.

On August 10, 2007, the Company entered into a new Revolving Credit Agreement (or 2007 Revolver) to replace the 2006 Revolver. The 2007 Revolver provides for borrowings up to $25,000 and

Table of Contents

Lumber Liquidators, Inc.

Notes to Condensed Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

(unaudited)

expires on August 10, 2012. Amounts outstanding under the 2007 Revolver are subject to an interest rate of LIBOR + 0.50%, which may increase based on financial performance criteria. The 2007 Revolver allows for letters of credit up to $5,000, has no mandated payment provisions and the Company pays a fee of 0.125% per annum on any unused portion of the Revolver. The agreement and related security agreement for the 2007 Revolver contain certain defined covenants and restrictions, including the maintenance of certain financial ratios.

NOTE 4. STOCK-BASED COMPENSATION

At June 30, 2007, the Company maintained various stock option plans (the Option Plans) that provided for the issuance of nonqualified and incentive stock options to acquire up 2.3 million shares of common stock. These stock options may be granted by the Board of Directors to employees, directors and officers of the Company. The exercise price for incentive stock options shall not be less than the fair market value of the shares on the date of grant. Options granted under the Option Plans expire no later than ten years from the date of grant. The vesting period assigned to stock option grants is at the discretion of the Board of Directors on a grant by grant basis.

During the quarter ended June 30, 2007, the Company issued options to purchase 50,000 shares of common stock with an exercise price of $10.26. As of June 30, 2007, there were 1,846,847 stock options outstanding, with an intrinsic value of $10,608. The exercise prices ranged from $7.58 to $10.26 with a weighted average exercise price of $7.76. These options had a weighted average contractual term of 9.2 years as of June 30, 2007. As of June 30, 2007, no stock options were exercisable. The Company recorded stock-based compensation expense related to the Option Plans of $435 and $858 for the three and six months ended June 30, 2007, respectively. There were no grants under the Option Plans through June 30, 2006.

As of June 30, 2007, total unrecognized compensation cost related to unvested options was approximately $5,463 net of estimated forfeitures, which is expected to be recognized over a weighted average period of approximately 3.1 years.

In August 2007, our Board of Directors adopted the Lumber Liquidators, Inc. 2007 Equity Compensation Plan (the 2007 Plan) and the Company s shareholders will approve the 2007 Plan prior to the completion of this offering. The 2007 Plan provides for the grant of stock-based awards to employees, non-employee directors and other service providers. The number of shares of common stock authorized for issuance with respect to awards granted under the 2007 Plan is 4.3 million, reduced by (i) any shares that have been issued under either the 2004 Stock Option and Grant Plan and the 2006 Equity Plan for Non-Employee Directors (collectively, the Prior Plans), and (ii) any shares that are subject to outstanding awards under the Prior Plans that have not been forfeited or cancelled. No additional options will be issued under the Prior Plans.

The Company has a stock unit plan for regional store management, the 2006 Stock Unit Plan for Regional Managers (the 2006 Regional Plan). The 2006 Regional Plan has 85,000 stock units outstanding and the Founder will contribute the 85,000 shares of common stock necessary to provide for the exercise of the stock units. No additional grants of stock units are available under the 2006 Regional Plan. The stock units vest over a five year period, but expire without value unless the IPO or a sale event, as defined, occur, and as such, the Company has not recorded compensation expense related to the 2006 Regional Plan as of June 30, 2007.

F-26

Table of Contents

Lumber Liquidators, Inc.

Notes to Condensed Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

(unaudited)

The Company had a stock warrant plan (the Warrant Plan), established in 2004, with a senior executive who separated from the Company in May 2006. As a result of the separation during the second quarter of 2006, the Company reversed the $259 of compensation expense that had been previously recognized.

The Company is also a party to a stock-based agreement between the Founder and his brother, Kevin Sullivan, a regional manager (or Kevin), accounted for as a variable performance plan (the Variable Plan). The Variable Plan was established in 1998, and modified in August 2005. The Variable Plan awarded Kevin the right (the Variable Right) to a fixed ownership percentage of 2.5% on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria, primarily a comparison of the net income of the region under Kevin s management to total Company net income on a trailing twelve-month basis. The Variable Right is exercisable for shares of common stock, contributed by the Founder, in conjunction with the IPO or a sale event, as defined. On February 1, 2008, the Variable Plan allows for a cash settlement of the Variable Right at a defined, performance based, value through put-call provisions, which may be executed by either the Founder or Kevin. The Founder is liable for the cash payment, and the Company guarantees the performance. Immediately prior to the completion of the IPO or sale event, however, the Variable Right is considered exercised in full, and any cash settlement provisions via put-call rights terminate. The Company recorded stock-based compensation expense under the Variable Plan of $2,649 and $3,052 for the three and six months ended June 30, 2007, respectively and, due to the put-call provisions, carried a short-term liability of $12,184 as of June 30, 2007. The Company recorded stock-based compensation expense under the Variable Plan of $260 and $520 for the three and six months ended June 30, 2006.

NOTE 5. NET INCOME PER COMMON SHARE
The following table sets forth the computation of basic and diluted net income per common share:

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Net Income	$ 2,345	$ 4,819	$ 4,576	$ 8,379
Weighted Average Common Shares Outstanding Basic	15,000,100	15,000,100	15,000,100	15,000,100
Effect of Dilutive Securities				
Redeemable Preferred Stock	7,952,018	7,952,018	7,952,018	7,952,018
Stock Options	151,375		75,688	
Warrants		63,392		74,345
Weighted Average Common Shares Outstanding Diluted	23,103,493	23,015,510	23,027,806	23,026,463
Net Income Per Common Share Basic	$ 0.16	$ 0.32	$ 0.31	$ 0.56

Net Income Per Common Share Diluted	$	0.10	$	0.21	$	0.20	$	0.37

For the three and six months ended June 30, 2007, options to purchase 50,000 shares of common stock were not included in the computation of Weighted Average Common Shares Outstanding Diluted because the effect world be antidilutive. There were no warrants outstanding after the Former Executive separated from the Company in May 2006.

Table of Contents

Lumber Liquidators, Inc.

Notes to Condensed Financial Statements (Continued)

(amounts in thousands, except share data and per share amounts)

(unaudited)

NOTE 6. RELATED PARTY TRANSACTIONS

As of June 30, 2007, the Company leases the Toano facility and 23 of its 103 other store locations from ANO LLC, a company that is wholly owned by the Founder. The Company leases one store location each from DORA Real Estate Company, LLC, Wood on Wood Road, Inc. and BMT Holdings, LLC. DORA and Wood on Wood are wholly owned by the Founder, and he has a 50% membership interest in BMT. Rental expense related to these companies for the three and six months ended June 30, 2007 was $615 and $1,205, respectively. Rental expense related to these companies for the three and six months ended June 30, 2006 was $560 and $1,113, respectively.

NOTE 7. COMMITMENTS AND CONTINGENCIES

In July 2006, the Company entered into a purchase agreement with a vendor where the Company would purchase a total of approximately 27 million square feet of the vendor s assorted products over a four-year period, with the unit prices set at the time a purchase order is created/accepted.

Legal Proceedings

On January 4, 2007, Clifford Wayne Bassett and Clifford Wayne Bassett, MD, PC (together Dr. Bassett) filed a lawsuit entitled Clifford Wayne Bassett et al. v. Lumber Liquidators, Inc. et al., in the U.S. District Court for the Southern District of New York, against the Company, E.W. Scripps Company (Scripps) and others. The Company purchased an article from Scripps describing the benefits of hardwood flooring in relation to other types of flooring. The article contained a quote by Dr. Bassett, an allergist, who claims that the use of the quote was unauthorized. Dr. Bassett has asserted damages in excess of $10 million. The matter is in the early stages of litigation and, while there is reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss, if any, at this time. In connection with SFAS No. 5, Accounting for Contingencies (or SFAS 5) paragraph 8, we have not made any provision in connection with this matter. The Company intends to defend vigorously against this claim and, to the extent warranted, seek contribution or indemnification from other parties.

On July 12, 2007, the Company received a copy of a Demand for Arbitration, dated July 11, 2007, in which the Former Executive contends that the Company breached its obligations to him upon his resignation of employment on May 31, 2006. When he terminated his employment, the Former Executive asserted that he did so for good reason , as defined within his employment agreement and the Warrant Plan. The Company responded to the Former Executive that his contention regarding his termination for good reason was erroneous. Under the provisions of his employment agreement, his termination for good reason would entitle him to 2 years of wages (approximately $0.7 million) and benefits, and under the provisions of the Warrant Plan, he would be entitled to 1% of the outstanding common stock. While there is reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss, if any, at this time. In connection with SFAS 5 paragraph 8, we have not made any provision in connection with this matter. The Company intends to defend itself vigorously against the Former Executive s claim.

The Company is from time to time subject to claims and disputes arising in the normal course of business. In the opinion of management, while the outcome of any such claims and disputes cannot be predicted with certainty, the ultimate liability of the Company in connection with these matters is not expected to have a material adverse effect on the Company s results of operations, financial position or cash flows.

F-28

Table of Contents

Table of Contents

11,500,000 Shares

Lumber Liquidators, Inc.

Common Stock

PROSPECTUS

Goldman, Sachs & Co. **Merrill Lynch & Co.**

Lehman Brothers

Banc of America Securities LLC

Piper Jaffray

No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus or any free writing prospectus prepared by us or on our behalf. You must not rely on any unauthorized information or representations. This prospectus is an offer to sell only the shares offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus is current only as of its date.

Through and including , 2007 (the 25th day after the date of this prospectus), all dealers effecting transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to a dealer s obligation to deliver a prospectus when acting as an underwriter and with respect to an unsold allotment or subscription.

, 2007

Table of Contents

PART II

Information Not Required in Prospectus

Item 13. Other Expenses of Issuance and Distribution

The following table shows the costs and expenses, other than underwriting discounts and commissions, payable in connection with the issuance and distribution of the securities being registered. Except as otherwise noted, we will pay all of these amounts. All amounts except the SEC registration fee and the NASD filing fee are estimated.

SEC Registration Fee	5,685
NASD Filing Fee	20,500
NYSE Listing Fees	160,000
Accounting Fees and Expenses	850,000
Legal Fees and Expenses	1,200,000
Printing Fees and Expenses	200,000
Transfer Agent and Registrar Fees and Expenses	15,000
Blue Sky Fees and Expenses	15,000
Miscellaneous	33,815
Total	2,500,000

* To be provided by amendment.

Item 14. Indemnification of Directors and Officers

Section 145 of the Delaware General Corporation Law authorizes a corporation to indemnify its directors, officers, employee and agents against expenses (including attorney s fees), judgments, fines and amounts paid in settlement reasonably incurred, provided they act in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal proceeding, had no reasonable cause to believe their conduct was unlawful, although in the case of proceedings brought by or on behalf of the corporation, such indemnification is limited to expenses and is not permitted if the individual is adjudged liable to the corporation (unless the Delaware Court of Chancery or the court in which such proceeding was brought determines otherwise in accordance with the Delaware General Corporation Law). Section 102 of the Delaware General Corporation Law authorizes a corporation to limit or eliminate its directors liability to the corporation or its stockholders for monetary damages for breaches of fiduciary duties, other than for (i) breaches of the duty of loyalty; (ii) acts or omissions not in good faith or that involve international misconduct or knowing violations of law; (iii) unlawful payments of dividends, stock purchases or redemptions; or (iv) transactions from which a director derives an improper personal benefit. Our certificate of incorporation contains such a provision.

Our bylaws incorporate Section 145 of the Delaware General Corporation Law, which provides that we will indemnify each director and officer against all claims and expenses resulting from the fact that such person was an director, officer, agent or employee of the registrant. A claimant is eligible for indemnification if the claimant (i) acted in good faith and in a manner that, in the claimant s reasonable belief, was in or not opposed to the best interest of the registrant; or (ii) in the case of a criminal proceeding, had no reasonable cause to believe the claimant s conduct was unlawful. This determination will be made by our disinterested directors, our shareholders or independent counsel in accordance with Section 145 of the Delaware General Corporation Law.

Section 145 of the Delaware General Corporation Law authorizes a corporation to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation against any liability asserted against and incurred by such person in any such capacity, or arising out of such person s status as such. We have obtained liability insurance covering our directors and officers for claims asserted against them or incurred by them in such capacity.

II-1

Table of Contents

The underwriting agreement between Lumber Liquidators and the underwriters will provide that the underwriters are obligated, under certain circumstances, to indemnify our directors, officers and controlling persons against certain liabilities, including liabilities under the Securities Act. Reference is made to the form of underwriting agreement filed as Exhibit 1.1 hereto.

Reference is made to Item 17 for our undertakings with respect to indemnification for liabilities arising under the Securities Act.

Item 15. Recent Sales of Unregistered Securities

In the three years preceding the filing of this registration statement, we have sold and issued the following unregistered securities:

(1) On December 6, 2004, we issued an aggregate of 7,952,018 million shares of series A convertible preferred stock, par value $0.01, for an aggregate offering price of $35.0 million to TA IX L.P., TA/Atlantic and Pacific IV L.P., TA Strategic Partners Fund A L.P., TA Strategic Partners Fund B L.P. and TA Investors II L.P. The ultimate general partner or manager of each of such entity is TA Associates, Inc.

(2) On July 13, 2006, we granted 952,691 stock options relating to our common stock with an exercise price of $7.58 per share to certain members of our executive management under our 2004 Option Plan.

(3) On July 13, 2006, we granted 79,156 stock options relating to our common stock with an exercise price of $7.58 per share to certain non-employee directors under our 2006 Director Plan.

(4) In July 2006 we granted 85,000 stock units relating to our common stock to certain regional managers under our 2006 Regional Plan.

(5) On October 18, 2006, we granted 765,000 stock options relating to our common stock with an exercise price of $7.83 per share to certain members of our executive management under our 2004 Option Plan.

(6) On April 27, 2007, we granted 50,000 stock options relating to our common stock with an exercise price of $10.26 per share to a member of our executive management under our 2004 Option Plan.

The issuances of securities described in paragraphs (2), (3), (4) and (5) above were made in reliance upon Section 4(2) under the Securities Act in that such issuance did not involve a public offering or under Rule 701 promulgated under the Securities Act, in that they were offered and sold either pursuant to written compensatory plans or pursuant to a written contract relating to compensation, as provided by Rule 701. The issuances of securities described in paragraph (1) above were made in reliance upon Section 4(2) and/or Regulation D promulgated thereunder as transactions not involving any public offering, to purchasers who represented that they were accredited investors as defined under the Securities Act. All share certificates representing the securities issued in such transactions contain appropriate restrictive legends. All of the foregoing shares are deemed restricted securities for the purposes of the Securities Act.

Item 16. Exhibits and Financial Statement Schedules

(a) Exhibits

See the Exhibit Index, which follows the signature pages and is incorporated herein by reference.

(b) Financial Statement Schedules

Schedules not listed above have been omitted because the information to be set forth therein is not material, not applicable or is shown in the financial statements or notes thereto.

Table of Contents

Item 17. Undertakings

(a) The undersigned registrant hereby undertakes to provide to the underwriters at the closing specified in the underwriting agreement, certificates in such denominations and registered in such names as required by the underwriters to permit prompt delivery to each purchaser.

(b) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer, or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

(c) The undersigned registrant hereby undertakes that:

(1) For purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by the registrant pursuant to Rule 424(b)(1) or (4) or 497(h) under the Securities Act shall be deemed to be part of this registration statement as of the time it was declared effective.

(2) For the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Toano, State of Virginia, on October 17, 2007.

Lumber Liquidators, Inc.

By: /s/ Jeffrey W. Griffiths

Jeffrey W. Griffiths

President, Chief Executive Officer and Director

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
* **Jeffrey W. Griffiths**	President, Chief Executive Officer and Director	October 17, 2007
* **Daniel E. Terrell**	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	October 17, 2007
* **Thomas D. Sullivan**	Chairman of our Board of Directors	October 17, 2007
* **Richard D. Tadler**	Director	October 17, 2007
* **Martin F. Roper**	Director	October 17, 2007
* **Douglas T. Moore**	Director	October 17, 2007
* **John M. Presley**	Director	October 17, 2007

*By: /s/ E. Livingston B. Haskell

E. Livingston B. Haskell, as Attorney-in-Fact

II-4

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
1.01	Form of Underwriting Agreement*
3.01	Form of Amended and Restated Articles of Incorporation*
3.02	Form of Amended and Restated By-Laws*
4.01	Form of Certificate of Common Stock of Lumber Liquidators, Inc.*
5.01	Opinion of Cleary Gottlieb Steen & Hamilton LLP*
10.01	Lumber Liquidators 2006 Equity Plan for Non-Employee Directors[#,**]
10.02	Lumber Liquidators 2004 Stock Option and Grant Plan[#,**]
10.03	Employment Agreement with Jeffrey W. Griffiths[#,**]
10.04	Employment Agreement with H. Franklin Marcus, Jr.[#,**]
10.05	Offer Letter Agreement with Robert M. Morrison[#,**]
10.06	Offer Letter Agreement with Marco Pescara[#,**]
10.07	Form of Non-Qualified Employee Stock Option Agreement[#,**]
10.08	Lease by and between ANO LLC and Lumber Liquidators (relating to Toano facility)**
10.09	Thomas D. Sullivan Stock Option Agreement and Lumber Liquidators, Inc. Guaranty Agreement, and amendment thereto[#,**]
10.10	Lumber Liquidators 2007 Equity Compensation Plan[#]
23.01	Consent of Cleary Gottlieb Steen & Hamilton LLP (included in Exhibit 5.01)*
23.02	Consent of Ernst & Young LLP
23.03	Consent of Macon F. Brock, Jr.**
24.01	Powers of Attorney**

* To be filed by amendment
** Previously filed
\# Indicates a management contract or a compensatory plan, contract or arrangement