VERACYTE, INC.
Form 10-Q
August 13, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from to

Commission file number 001-36156

VERACYTE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**20-5455398**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7000 Shoreline Court, Suite 250

South San Francisco, California 94080

(Address of principal executive offices, zip code)

(650) 243-6300

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant 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 x No o

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

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

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

As of August 3, 2015, there were 27,664,118 shares of common stock, par value $0.001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

VERACYTE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

	June 30, 2015 (Unaudited)	December 31, 2014 (Derived from audited financial statements)
Assets		
Current assets:		
Cash and cash equivalents	$ 51,045	$ 35,014
Accounts receivable, net of allowance of $92 and $84 as of June 30, 2015 and December 31, 2014	3,586	3,050
Supplies inventory	3,976	3,696
Prepaid expenses and other current assets	1,735	1,218
Deferred tax asset	254	300
Restricted cash	118	70
Total current assets	60,714	43,348
Property and equipment, net	4,211	4,161
Finite-lived intangible assets, net	15,733	
Indefinite-lived intangible assets: in-process research and development		16,000
Goodwill	1,057	1,057
Restricted cash	603	118
Other assets	185	155
Total assets	$ 82,503	$ 64,839
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,688	$ 7,397
Accrued liabilities	7,217	7,851
Deferred Genzyme co-promotion fee	1,897	1,897
Total current liabilities	11,802	17,145
Long-term debt	4,975	4,923
Deferred tax liability	254	300
Deferred rent, net of current portion	384	149
Deferred Genzyme co-promotion fee, net of current portion		948
Total liabilities	17,415	23,465
Commitments and contingencies (Note 5)		
Stockholders equity:		

Preferred stock, $0.001 par value; 5,000,000 shares authorized, no shares issued and outstanding as of June 30, 2015 and December 31, 2014				
Common stock, $0.001 par value; 125,000,000 shares authorized, 27,595,971 and 22,523,529 shares issued and outstanding as of June 30, 2015 and December 31, 2014, respectively		27		23
Additional paid-in capital		196,829		156,373
Accumulated deficit		(131,768)		(115,022)
Total stockholders equity		65,088		41,374
Total liabilities and stockholders equity	$	82,503	$	64,839

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

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VERACYTE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Unaudited)

(In thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenue	$ 11,908	$ 8,677	$ 23,126	$ 16,153
Operating expenses:				
Cost of revenue	5,139	3,966	9,705	7,573
Research and development	3,103	2,243	5,890	4,369
Selling and marketing	6,937	5,101	12,557	9,437
General and administrative	5,536	3,928	11,334	7,910
Intangible asset amortization	267		267	
Total operating expenses	20,982	15,238	39,753	29,289
Loss from operations	(9,074)	(6,561)	(16,627)	(13,136)
Interest expense	(90)	(113)	(177)	(224)
Other income, net	28	19	58	31
Net loss and comprehensive loss	$ (9,136)	$ (6,655)	$ (16,746)	$ (13,329)
Net loss per common share, basic and diluted	$ (0.35)	$ (0.31)	$ (0.69)	$ (0.63)
Shares used to compute net loss per common share, basic and diluted	26,048,934	21,237,196	24,304,022	21,193,014

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

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VERACYTE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30,	
	2015	**2014**
Operating activities		
Net loss	$ (16,746)	$ (13,329)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	996	541
Bad debt expense	54	39
Genzyme co-promotion fee amortization	(949)	(1,250)
Stock-based compensation	2,712	1,367
Amortization of debt discount and issuance costs	23	54
Interest on debt balloon payment	39	40
Changes in operating assets and liabilities:		
Accounts receivable	(589)	(326)
Supplies inventory	(279)	(733)
Prepaid expenses and other current assets	(349)	93
Other assets	(39)	(11)
Accounts payable	(4,637)	3,377
Accrued liabilities and deferred rent	(569)	(2,526)
Net cash used in operating activities	(20,333)	(12,664)
Investing activities		
Purchases of property and equipment	(852)	(904)
Change in restricted cash	(533)	
Net cash used in investing activities	(1,385)	(904)
Financing activities		
Proceeds from issuance of common stock in a private placement, net of costs	37,258	
Commissions and issuance costs relating to the initial public offering		(129)
Proceeds from the exercise of common stock options	491	475
Net cash provided by financing activities	37,749	346
Net increase (decrease) in cash and cash equivalents	16,031	(13,222)
Cash and cash equivalents at beginning of period	35,014	71,220
Cash and cash equivalents at end of period	$ 51,045	$ 57,998

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

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VERACYTE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Veracyte, Inc. (the Company) was incorporated in the state of Delaware in August 2006 as Calderome, Inc. Calderome operated as an incubator until early 2008. In March 2008, the Company changed its name to Veracyte, Inc. Veracyte is a diagnostics company pioneering the field of molecular cytology to improve patient outcomes and lower healthcare costs. The Company specifically targets diseases that often require invasive procedures for an accurate diagnosis diseases where many healthy patients undergo costly interventions that ultimately prove unnecessary. The Company improves the accuracy of diagnosis at an earlier stage of patient care by deriving clinically actionable genomic information from cytology samples.

The Company s first commercial solution, the Afirma® Thyroid FNA Analysis, includes as its centerpiece the Gene Expression Classifier (GEC). The GEC helps physicians reduce the number of unnecessary surgeries by employing a proprietary 142-gene signature to preoperatively determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign. The comprehensive offering also includes cytopathology testing and the Afirma Malignancy Classifiers, launched in May 2014. The Company markets and sells Afirma through a co-promotion agreement with Genzyme Corporation, a subsidiary of Sanofi.

In September 2014, the Company acquired Allegro Diagnostics Corp. (Allegro) to accelerate its entry into pulmonology, the Company s second planned clinical area. Allegro was focused on the development of genomic tests to improve the preoperative diagnosis of lung cancer. In April 2015, the Company entered the lung cancer diagnostics market with the Percepta Bronchial Genomic Classifier, a new genomic test to resolve ambiguity in lung cancer diagnosis.

In April 2015, the Company received $37.3 million in net proceeds from the sale of its common stock in a private placement. See Note 7.

The Company s operations are based in South San Francisco, California and Austin, Texas, and it operates in one segment in the United States.

Basis of Presentation

The accompanying interim period condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (SEC)

regarding interim financial reporting. The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated in consolidation. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet as of June 30, 2015, the condensed consolidated statements of operations and comprehensive loss and the condensed consolidated statements of cash flows for the three and six months ended June 30, 2015 and 2014, are unaudited, but include all adjustments, consisting only of normal recurring adjustments, which the Company considers necessary for a fair presentation of its financial position, operating results and cash flows for the periods presented. The condensed consolidated balance sheet at December 31, 2014 has been derived from audited financial statements. The results for the three and six months ended June 30, 2015 are not necessarily indicative of the results expected for the full fiscal year or any other period.

The accompanying interim period condensed consolidated financial statements and related financial information included in this Quarterly Report on Form 10-Q should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2014.

Use of Estimates

The preparation of the unaudited interim consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant items subject to such estimates include: revenue recognition; contractual allowances; allowance for doubtful accounts; the useful lives of property and equipment; the recoverability of long-lived assets; stock options; income tax uncertainties, including a valuation allowance for deferred tax assets; and contingencies. The Company bases these estimates on historical and anticipated results, trends, and various other assumptions that the Company believes are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses that are not readily apparent from other sources. Actual results could differ from these estimates and assumptions.

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Concentrations of Credit Risk and Other Risks and Uncertainties

The Company s cash and cash equivalents are deposited with one major financial institution in the United States, as required by the loan and security agreement discussed in Note 6. Deposits in this institution may exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Several of the components of the Company s sample collection kit and test reagents are obtained from single-source suppliers. If these single-source suppliers fail to satisfy the Company s requirements on a timely basis, it could suffer delays in being able to deliver its diagnostic solutions, a possible loss of revenue, or incur higher costs, any of which could adversely affect its operating results.

The Company is also subject to credit risk from its accounts receivable related to its sales of Afirma. The Company generally does not perform evaluations of customers financial condition and generally does not require collateral.

Through June 30, 2015, all of the Company s revenues have been derived from the sale of Afirma. To date, Afirma has been delivered primarily to physicians in the United States. The Company s third-party payers in excess of 10% of revenue and their related revenue as a percentage of revenue were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Medicare	28%	27%	26%	28%
Aetna	9%	12%	9%	11%
UnitedHealthcare	14%	16%	14%	16%
	51%	55%	49%	55%

As the number of payers reimbursing for Afirma increases, the percentage of revenue derived from Medicare and other significant third-party payers has changed and will continue to change as a percentage of revenue.

The Company s significant third-party payers and their related accounts receivable balance at June 30, 2015 and December 31, 2014 as a percentage of total accounts receivable are as follows:

	June 30, 2015	December 31, 2014
Medicare	30%	64%
Aetna	25%	12%
UnitedHealthcare	28%	14%

No other third-party payer represented more than 10% of the Company s accounts receivable balances at those dates.

Cash Equivalents

Cash equivalents consist of amounts invested in a money market account primarily consisting of U.S. Treasury reserves.

Restricted Cash

The Company had deposits of $118,000 as of June 30, 2015 and December 31, 2014, restricted from withdrawal and held by a bank in the form of collateral for irrevocable standby letters of credit totaling $118,000 held as security for the lease of the Company s headquarters and laboratory facilities in South San Francisco that expires March 31, 2016. This restricted cash is included in current assets as of June 30, 2015 and in long-term assets as of December 31, 2014 on the Company s condensed consolidated balance sheets. The Company also had deposits of $603,000 included in long-term assets as of June 30, 2015, restricted from withdrawal and held by a bank in the form of collateral for an irrevocable standby letter of credit totaling $603,000 held as security for the lease of the Company s new headquarters and laboratory facilities in South San Francisco signed on April 29, 2015.

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The Company reserved $70,000 in cash as of December 31, 2014 to cover liabilities associated with the acquisition of Allegro. This amount was paid in March 2015. This restricted cash was included in current assets on the Company s condensed consolidated balance sheet at December 31, 2014.

Allowance for Doubtful Accounts

The Company estimates an allowance for doubtful accounts against its individual accounts receivable based on estimates of expected reimbursement consistent with historical payment experience in relation to the amounts billed. Bad debt expense is included in general and administrative expense on the Company s statements of operations and comprehensive loss. Accounts receivable are written off against the allowance when there is substantive evidence that the account will not be paid.

The balance of allowance for doubtful accounts as of June 30, 2015 and December 31, 2014 was $92,000 and $84,000, respectively. Bad debt expense was $32,000 and $54,000 for the three and six months ended June 30, 2015, respectively, and $11,000 and $39,000 for the three and six months ended June 30, 2014, respectively. Write offs for doubtful accounts of $26,000 and $46,000 were recorded against the allowance during the three and six months ended June 30, 2015, respectively. Write offs for doubtful accounts of $34,000 were recorded against the allowance during the three and six months ended June 30, 2014.

Supplies Inventory

Supplies inventory consists of test reagents and other consumables used in the sample collection kits and in cytopathology and GEC test processing and are valued at the lower of cost or market value. Cost is determined using actual costs on a first-in, first-out basis.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally between three and five years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the term of the lease. Maintenance and repairs are charged to expense as incurred, and improvements and betterments are capitalized. When assets are retired or otherwise disposed of, the cost and accumulated depreciation are removed from the balance sheet and any resulting gain or loss is reflected in the statements of operations and comprehensive loss in the period realized.

Internal-use Software

The Company capitalizes costs incurred in the application development stage to design and implement the software used in the tracking and reporting of laboratory activity. Costs incurred in the development of application software are capitalized and amortized over an estimated useful life of three years on a straight-line basis. The total cost, accumulated depreciation and net book value was $1.1 million, $440,000 and $654,000, respectively, as of June 30, 2015, and was $927,000, $330,000 and $597,000, respectively, as of December 31, 2014, and are included in property and equipment in the Company s condensed consolidated balance sheets. During the six months ended June 30, 2015 and 2014, the Company capitalized $167,000 and $125,000, respectively, of software development costs. Amortization expense totaled $55,000 and $109,000 in the three and six months ended June 30, 2015, respectively, and $32,000 and $64,000 in the three and six months ended June 30, 2014, respectively.

Business Combination

The Company accounts for acquisitions using the acquisition method of accounting which requires the recognition of tangible and identifiable intangible assets acquired and liabilities assumed at their estimated fair values as of the business combination date. The Company allocates any excess purchase price over the estimated fair value assigned to the net tangible and identifiable intangible assets acquired and liabilities assumed to goodwill. Transaction costs are expensed as incurred in general and administrative expenses. Results of operations and cash flows of acquired companies are included in the Company s operating results from the date of acquisition.

Finite-lived Intangible Assets

Finite-lived intangible assets relates to intangible assets reclassified from indefinite-lived intangible assets, following the launch of Percepta in April 2015. The Company amortizes finite-lived intangible assets using the straight-line method over their estimated useful life. The estimated useful life of 15 years was used for the intangible asset related to the Percepta test based on management s estimate of product life, product life of other diagnostic tests and patent life, The Company reviews this finite-lived intangible asset for impairment when facts or circumstances indicate a reduction in the fair value below its carrying amount.

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Indefinite-lived Intangible Assets In-process Research and Development

The Company s indefinite-lived intangible assets are comprised of acquired in-process research and development (IPR&D). The fair value of IPR&D acquired through a business combination is capitalized as an indefinite-lived intangible asset until the completion or abandonment of the related research and development activities. When research and development is complete, the associated assets are amortized on a straight-line basis over their estimated useful lives. IPR&D is tested for impairment annually or more frequently if events or circumstances indicate that the fair value may be below the carrying value of the asset. The Company recognizes an impairment loss when the total of estimated future undiscounted cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. Impairment, if any, would be assessed using discounted cash flows or other appropriate measures of fair value. There was no impairment for the six months ended June 30, 2015.

Goodwill

Goodwill, derived from the Company s acquisition of Allegro, is reviewed for impairment annually or more frequently if events or circumstances indicate that it may be impaired. The Company s goodwill evaluation is based on both qualitative and quantitative assessments regarding the fair value of goodwill relative to its carrying value. The Company has determined that it operates in a single segment and has a single reporting unit associated with the development and commercialization of diagnostic products. In the event the Company determines that it is more likely than not the carrying value of the reporting unit is higher than its fair value, quantitative testing is performed comparing recorded values to estimated fair values. If impairment is present, the impairment loss is measured as the excess of the recorded goodwill over its implied fair value. The Company performs its annual evaluation of goodwill during the fourth quarter of each fiscal year. There was no impairment for the six months ended June 30, 2015.

Bonus Accruals

The Company accrues for liabilities under discretionary employee and executive bonus plans. These estimated compensation liabilities are based on progress against corporate objectives approved by the Board of Directors, compensation levels of eligible individuals, and target bonus percentage levels. The Board of Directors and the Compensation Committee of the Board of Directors review and evaluate the performance against these objectives and ultimately determine what discretionary payments are made. The Company accrued $1.3 million and $1.1 million as of June 30, 2015 and December 31, 2014, respectively, for liabilities associated with these employee and executive bonus plans which are included in accrued liabilities in the Company s condensed consolidated balance sheets.

Fair Value of Financial Instruments

The carrying amounts of certain financial instruments including cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued liabilities approximate fair value due to their relatively short maturities.

Revenue Recognition

The Company s revenue is generated from the provision of diagnostic services using the Afirma solution. The Company s service is completed upon the delivery of test results to the prescribing physician which triggers the billing for the service. The Company recognizes revenue related to billings for Medicare and commercial payers on an accrual basis, net of contractual adjustments, when a reasonable estimate of reimbursement can be made. These contractual adjustments represent the difference between the list price (the billing rate) and the reimbursement rate for each payer. Upon ultimate collection, the amount received from Medicare and commercial payers where reimbursement was estimated is compared to previous estimates and the contractual allowance is adjusted accordingly. Until a contract has been negotiated with a commercial payer or governmental program, the Afirma solution may or may not be covered by these entities existing reimbursement policies. In addition, patients do not enter into direct agreements with the Company that commit them to pay any portion of the cost of the tests in the event that their insurance declines to reimburse the Company. In the absence of an agreement with the patient or other clearly enforceable legal right to demand payment from the patient, the related revenue is only recognized upon the earlier of payment notification, if applicable, or cash receipt.

For all services performed, the Company considers whether or not the following revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; and a reasonable estimate of reimbursement can be made.

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Persuasive evidence of an arrangement exists and delivery is deemed to have occurred upon delivery of a patient report to the prescribing physician. The assessment of whether a reasonable estimate of reimbursement can be made requires significant judgment by management. Where management s judgment indicates a reasonable estimate of reimbursement can be made, revenue is recognized upon delivery of the patient report. Some patients have out-of-pocket costs for amounts not covered by their insurance carrier, and the Company may bill the patient directly for these amounts in the form of co-payments and co-insurance in accordance with their insurance carrier and health plans. Some payers may not cover the Company s GEC as ordered by the prescribing physician under their reimbursement policies. The Company pursues reimbursement from such patients on a case-by-case basis. In the absence of contracted reimbursement coverage or the ability to reasonably estimate reimbursement, the Company recognizes revenue upon receipt of third-party payer notification of payment or when cash is received.

Revenue recognized when cash is received and on an accrual basis for the three and six months ended June 30, 2015 and 2014 was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenue recognized when cash is received	$ 5,321	$ 6,046	$ 11,153	$ 11,163
Revenue recognized on an accrual basis	6,587	2,631	11,973	4,990
Total	$ 11,908	$ 8,677	$ 23,126	$ 16,153

Cost of Revenue

Cost of revenue is expensed as incurred and includes material and service costs, cytopathology testing services performed by a third-party pathology group, stock-based compensation expense, direct labor costs, equipment and infrastructure expenses associated with testing samples, shipping charges to transport samples, and allocated overhead including rent, information technology, equipment depreciation and utilities.

Research and Development

Research and development costs are charged to operations as incurred. Research and development costs include payroll and personnel-related expenses, stock-based compensation expense, prototype materials, laboratory supplies, consulting costs, costs associated with setting up and conducting clinical studies at domestic and international sites, and allocated overhead including rent, information technology, equipment depreciation and utilities.

Income Taxes

The Company accounts for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company assesses all material positions taken in any income tax return, including all significant uncertain positions, in all tax years that are still subject to assessment or challenge by relevant taxing authorities. The Company s assessment of an uncertain tax position begins with the initial determination of the position s sustainability and is measured at the largest amount of benefit that is more-likely-than-not of being realized upon ultimate settlement. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and the Company will determine whether (i) the factors underlying the sustainability assertion have changed and (ii) the amount of the recognized tax benefit is still appropriate. The recognition and measurement of tax benefits requires significant judgment. Judgments concerning the recognition and measurement of a tax benefit may change as new information becomes available.

Stock-based Compensation

Stock-based compensation expense for equity instruments issued to employees is measured based on the grant-date fair value of the awards. The fair value of each employee stock option is estimated on the date of grant using the Black-Scholes option-pricing model. The Company recognizes compensation costs on a straight-line basis for all employee stock-based compensation awards that are expected to vest over the requisite service period of the awards, which is generally the awards vesting period. Forfeitures are required to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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Equity awards issued to non-employees are valued using the Black-Scholes option-pricing model and are subject to re-measurement as the underlying equity awards vest.

Net Loss per Common Share

Basic net loss per common share is calculated by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding during the period, without consideration of common stock equivalents. Diluted net loss per common share is computed by dividing net loss attributable to common stockholders by the weighted-average number of common share equivalents outstanding for the period determined using the treasury stock method. Potentially dilutive securities consisting of options to purchase common stock of 4,223,267 and 2,983,509 for the six months ended June 30, 2015 and 2014, respectively, are considered to be common stock equivalents and were excluded from the calculation of diluted net loss per common share because their effect would be anti-dilutive for all periods presented.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. Adoption is permitted as early as the first quarter of 2017 and is required by the first quarter of 2018. The Company has not yet selected a transition method and is currently evaluating the potential effect of the updated standard on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, to require debt issuance costs to be presented as an offset against debt outstanding. The ASU is effective for interim and annual periods beginning after December 15, 2015. Adoption of the ASU is retrospective to each prior period presented. The Company does not anticipate that the adoption of the ASU will have a material impact on its condensed consolidated balance sheets.

2. Business Combination

On September 16, 2014, the Company acquired Allegro via a merger with Full Moon Acquisition, Inc., a wholly-owned subsidiary of the Company. Allegro was a privately-held company based in Maynard, Massachusetts, focused on the development of genomic tests to improve the preoperative diagnosis of lung cancer. Allegro merged with Full Moon (the Merger), with Allegro surviving the Merger as a wholly-owned subsidiary of the Company. The subsidiary was dissolved in July 2015. At the effective time of the Merger, each share of the common stock of Full Moon issued and outstanding immediately prior to the effective time of the Merger was automatically converted into one share of common stock of Allegro and represented the only outstanding common stock of Allegro at the effective time of the Merger; all previously issued and outstanding shares of common stock of Allegro were canceled. The Series A preferred stock of Allegro issued and outstanding immediately prior to the effective time of the Merger was canceled and automatically converted into the right to receive a total of 964,377 shares of the Company s common stock and $2.7 million in cash. Outstanding indebtedness of Allegro totaling $4.3 million was settled in cash by the Company on the effective date of the Merger. All outstanding stock options under Allegro s equity incentive plan were canceled.

The acquisition of Allegro accelerated the Company s entry into the pulmonology diagnostics market. Allegro s lung cancer test, called Percepta, is designed to help physicians determine which patients with lung nodules who have had a non-diagnostic bronchoscopy result are at low risk for cancer and can thus be safely monitored with CT scans rather than undergoing invasive procedures. The Company launched the Percepta test in April 2015.

The Merger was accounted for using the acquisition method of accounting with the Company treated as the accounting acquirer. The purchase price was allocated based on the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition.

The Company incurred approximately $0.5 million in acquisition-related costs related to the Merger, which primarily consisted of legal, accounting and valuation-related expenses. In addition, the Company incurred $1.2 million related to transaction bonuses and severance payments to former Allegro employees associated with the Merger. These expenses were recorded in general and administrative expense in the condensed consolidated statements of operations and comprehensive loss.

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The acquisition consideration was comprised of (in thousands):

Stock	$	10,078
Cash		2,725
Payment of outstanding indebtedness		4,290
Total acquisition consideration	$	17,093

The stock consideration of $10.1 million was determined based on the closing price of the Company s common stock on September 16, 2014 ($10.45 per share).

The fair value of the assets acquired and liabilities assumed at the closing date of the Merger are summarized below (in thousands):

Cash and cash equivalents	$	29
Other assets, net		7
In-process research and development (IPR&D)		16,000
Goodwill		1,057
Total acquisition consideration	$	17,093

The fair value of IPR&D was determined using the multi-period excess earnings method of the income approach, which estimates the economic benefits of the IPR&D over multiple time periods by identifying the cash flows associated with the use of the asset, based on forecasts prepared by management, and deducting a periodic charge reflecting a fair return for the use of contributory assets. The forecasted cash flows were discounted based on a discount rate of 18.5%. The discount rate represents the Company s weighted average return on assets and was benchmarked against the internal rate of return and cost of capital of guideline publicly traded companies. The fair value of the IPR&D was capitalized as of the closing date of the Merger and was accounted for as an indefinite-lived intangible asset prior to the beginning of amortization.

Amortization of the IPR&D began in April 2015 when research and development activities were deemed to be completed and is recorded on a straight-line basis. The amortization period of the IPR&D is over its estimated useful life of 15 years after taking into consideration expected use of the asset, legal or regulatory provisions that may limit or extend the life of the asset, as well as the effects of obsolescence and other economic factors. Amortization of $267,000 was recorded in the three months and six months ended June 30, 2015, as compared with $0 for the three and six months ended June 30, 2014. Accumulated amortization was $267,000 as of June 30, 2015. Amortization expense will be approximately $1.1 million per year.

Goodwill, which represents the purchase price in excess of the fair value of net assets acquired, is not expected to be deductible for income tax purposes. This goodwill is reflective of the value derived from the acceleration of the Company s entry into the pulmonology market.

The following pro forma financial information is based on the historical financial statements of the Company and presents the Company s results as if the Merger had occurred as of January 1, 2013 (in thousands):

	Three Months Ended June 30, 2014	Six Months Ended June 30, 2014
Revenue	$ 8,677	$ 16,153
Net loss	$ (7,284)	$ (14,495)

The pro forma results present the combined historical results of operations with adjustments to reflect one-time charges representing the elimination of interest expense related to Allegro indebtedness of $1.9 million and $2.0 million for the three and six months ended June 30, 2014, respectively.

The pro forma information presented does not purport to present what the actual results would have been had the Merger actually occurred on January 1, 2013, nor is the information intended to project results for any future period.

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3. Accrued Liabilities

Accrued liabilities consisted of the following (in thousands):

	June 30, 2015	December 31, 2014
Accrued compensation expenses	$ 3,277	$ 2,673
Accrued Genzyme co-promotion fees	1,685	3,309
Accrued other	2,255	1,869
Total accrued liabilities	$ 7,217	$ 7,851

4. Fair Value Measurements

The Company records its financial assets and liabilities at fair value. The carrying amounts of certain financial instruments of the Company, including cash and cash equivalents, prepaid expenses and other current assets, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities. The carrying value of debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. The accounting guidance for fair value provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The accounting guidance establishes a three-tiered hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value as follows:

- Level I: Inputs which include quoted prices in active markets for identical assets and liabilities.

- Level II: Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level III: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value of the Company s financial assets, which consist of money market funds, was $50.1 million and $33.2 million as of June 30, 2015 and December 31, 2014, respectively, and are Level I assets as described above.

5. Commitments and Contingencies

Operating Leases

The Company leases its headquarters and laboratory facilities in South San Francisco under a non-cancelable lease agreement that expires on March 31, 2016.

On April 29, 2015, the Company signed a non-cancelable lease agreement for approximately 59,000 square feet to serve as its new South San Francisco headquarters and laboratory facilities. The lease begins in June 2015 and ends in March 2026 and contains extension of lease term and expansion options. In conjunction with this lease, the landlord is providing funding of approximately $3.3 million for tenant improvements. As of June 30, 2015 the Company had recorded approximately $0.1 million as receivable from the landlord. The Company had deposits of $603,000 included in long-term assets as of June 30, 2015, restricted from withdrawal and held by a bank in the form of collateral for an irrevocable standby letter of credit totaling $603,000 held as security for the lease of the new headquarters and laboratory facilities.

The Company also leases laboratory space in Austin, Texas. The lease expires on July 31, 2018. The Company provided a security deposit of $75,000, which is included in other assets in the Company s condensed consolidated balance sheets as of June 30, 2015 and December 31, 2014.

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Future minimum lease payments under non-cancelable operating leases as of June 30, 2015, are as follows (in thousands):

Year Ending December 31,		Amounts
July through December 31, 2015	$	500
2016		1,822
2017		2,142
2018		2,102
2019		2,026
Thereafter		14,038
Total minimum lease payments	$	22,630

The Company recognizes rent expense on a straight-line basis over the non-cancelable lease period. Facilities rent expense was $352,000 and $213,000 for the three months ended June 30, 2015 and 2014, respectively, and $565,000 and $426,000 for the six months ended June 30, 2015 and 2014, respectively. Until the new headquarters is utilized, rent of approximately $500,000 per quarter will be charged to general and administrative expense.

Supplies Purchase Commitments

The Company had a non-cancelable purchase commitment with a supplier to purchase a minimum quantity of supplies for approximately $0.5 million at June 30, 2015, all of which is expected to be paid in 2015.

Debt Obligations

See Note 6.

Contingencies

From time to time, the Company may be involved in legal proceedings arising in the ordinary course of business. The Company believes there is no litigation pending that could have, individually or in the aggregate, a material adverse effect on the financial position, results of operations or cash flows.

6. Debt

In June 2013, the Company entered into a loan and security agreement (Original Loan) with a financial institution. The Original Loan provided for term loans of up to $10.0 million in aggregate. The Company drew down $5.0 million in funds under the agreement in June 2013, and did not draw the remaining $5.0 million on or before the expiration date of March 31, 2014. The Company was required to repay the outstanding principal in 30 equal installments beginning 18 months after the date of the borrowing, and the loan was due in full in June 2017. The Original Loan had an interest rate of 6.06% per annum, carried prepayment penalties of 2.25% and 1.50% for prepayment within one and two years, respectively, and 0.75% thereafter.

In December 2014, the Company amended certain terms and conditions of the Original Loan (Amended Loan). The Amended Loan provides for term loans of up to $15.0 million in aggregate, in three tranches of $5.0 million each. The Company borrowed $5.0 million under the first tranche in December 2014 and used the funds for repayment of the $5.0 million in principal outstanding under the Original Loan, in a cashless transaction. In addition, the Company paid the accrued but unpaid interest of $14,000 due on the Original Loan and the related end-of-term payment of $110,000. The Amended Loan waived the prepayment premium of $75,000 under the Original Loan and reduced the end-of-term payment of $225,000 under the Original Loan to $110,000. The second $5.0 million tranche under the Amended Loan is available through December 31, 2015, and the Company may borrow the third $5.0 million tranche any time through June 30, 2016 after achieving the third tranche revenue milestone as defined in the Amended Loan.

The carrying value of the debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. Under the Amended Loan, the Company is required to repay the outstanding principal in 24 equal installments beginning 24 months after the date of the borrowing, and the loan is due in full in December 2018. The first tranche of the Amended Loan bears interest at a rate of 5.00% per annum. The Amended Loan carries prepayment penalties of 2.00% and 1.00% for prepayment within one and two years, respectively, and no prepayment penalty thereafter. In connection with the Amended Loan, the Company paid approximately $45,000 in third-party fees.

The Amended Loan results in a debt modification under ASC 470-50, *Modifications and Extinguishments,* as the change in present value of the remaining cash flows associated with the Original Loan and Amended Loan are not substantial.

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As of June 30, 2015 and December 31, 2014, the net debt obligation was as follows (in thousands):

	June 30, 2015	December 31, 2014
Debt and unpaid accrued end-of-term payment	$ 5,042	$ 5,003
Unamortized note discount	(67)	(80)
Net debt obligation	$ 4,975	$ 4,923

Future principal payments under the Amended Loan are as follows (in thousands):

Year Ending December 31,	Amounts
July through December 31, 2015	$
2016	
2017	2,437
2018	2,563
Total	$ 5,000

The obligation includes an end-of-term payment of $237,500, representing 4.75% of the total outstanding principal balance, which accretes over the life of the loan as interest expense. As a result of the debt discount and the end-of-term payment, the effective interest rate for the loan differs from the contractual rate.

Interest expense on the debt was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Nominal interest	$ 63	$ 77	$ 125	$ 153
Amortization of debt discount	7	16	13	31
End-of-term payment	20	20	39	40
Total	$ 90	$ 113	$ 177	$ 224

Loans drawn under the Original Loan and the Amended Loan were used for working capital and general corporate purposes. The Company s obligations under the Amended Loan are secured by a security interest in substantially all of its assets, excluding its intellectual property and certain other assets. The Amended Loan contains customary conditions related to borrowing, events of default, and covenants, including covenants limiting the Company s ability to dispose of assets, undergo a change in control, merge with or acquire other entities, incur debt, incur liens, pay dividends or other distributions to holders of its capital stock, repurchase stock and make investments, in each case subject to certain exceptions. The Amended Loan also allows the lender to call the debt in the event there is a material adverse change in the Company s business or financial condition. The Company is required to be in compliance with a minimum liquidity or minimum revenue covenant. As of June 30, 2015, the Company was in compliance with all covenants.

7. Stockholders Equity

Common Stock

The Company s Restated Certificate of Incorporation authorizes the Company to issue 125,000,000 shares of common stock with a par value of $0.001 per share. The holder of each share of common stock shall have one vote for each share of stock. The common stockholders are also entitled to receive dividends whenever funds and assets are legally available and when declared by the Board of Directors, subject to the prior rights of holders of all series of convertible preferred stock outstanding. No dividends have been declared as of June 30, 2015.

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As of June 30, 2015 and December 31, 2014, the Company had reserved shares of common stock for issuance as follows:

	June 30, 2015	December 31, 2014
Options issued and outstanding	4,223,267	3,249,469
Options available for grant under stock option plans	1,103,928	1,341,252
Shares available for issuance under the ESPP	750,000	
Total	6,077,195	4,590,721

On April 28, 2015, the Company completed a private placement of 4,907,975 shares of its common stock to certain accredited investors (the Investors) at a purchase price of $8.15 per share. The sale of the shares was made pursuant to the terms of a Securities Purchase Agreement dated as of April 22, 2015. Gross proceeds to the Company were $40.0 million and the Company received $37.3 million in net proceeds, after deducting the placement agent fees and other expenses payable by the Company of $2.7 million. Under the Securities Purchase Agreement, the Company has agreed to use the net proceeds from the private placement for research and development, for product commercialization, and for working capital and general corporate purposes.

In connection with the sale of the common stock in the private placement, the Company entered into a Registration Rights Agreement with the Investors, pursuant to which the Company filed in May 2015 a registration statement with the SEC covering the resale of the common stock sold in the private placement. The Registration Rights Agreement includes customary indemnification rights in connection with the registration statement.

In June 2015, the Company filed a universal shelf registration statement with the SEC which provides the Company the ability to offer for sale up to $125.0 million of securities in a primary offering, including common stock, preferred stock, debt securities, depositary shares and rights. This shelf registration statement provides the Company, within the $125.0 million, the ability to offer for sale up to $25.0 million of its common stock at market prices pursuant to the terms of a controlled Equity Sales Agreement. This shelf registration statement also registered for resale up to 5,000,000 shares of common stock held by certain existing stockholders. Approximately $0.2 million of costs associated with this registration statement have been deferred in other current assets as of June 30, 2015.

Employee Stock Purchase Plan

In May 2015, the Company s stockholders approved the Company s Employee Stock Purchase Plan (ESPP). The ESPP provides eligible employees with an opportunity to purchase common stock from the Company and to pay for their purchases through payroll deductions. The ESPP will be implemented through a series of offerings of purchase rights to eligible employees. Under the ESPP, the Compensation Committee of the Company s Board of Directors may specify offerings with a duration of not more than 12 months, and may specify shorter purchase periods within each offering. During each purchase period, payroll deductions will accumulate, without interest. On the last day of the purchase period, accumulated payroll deductions will be used to purchase common stock for employees participating in the offering.

The purchase price will be specified pursuant to the offering, but cannot, under the terms of the ESPP, be less than 85% of the fair market value per share of the Company s common stock on either the last trading day preceding the offering date or on the purchase date, whichever is less.

The Company s Board of Directors has determined that the purchase periods initially shall have a duration of six months, will begin August 1, 2015 and that the purchase price will be 85% of the fair market value per share of the Company s common stock on either the last trading day preceding the offering date or the purchase date, whichever is less. The length of the purchase period applicable to U.S. employees and the purchase price may not be changed without the approval of the independent members of the Company s Board of Directors.

The Compensation Committee may specify that if the fair market value of a share of the Company s common stock on any purchase date within a particular offering period is less than or equal to the fair