NEVRO CORP
Form 10-Q
November 07, 2016
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 001-36715

Nevro Corp.

(Exact name of registrant as specified in its charter)

Delaware	56-2568057
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1800 Bridge Parkway

Redwood City, CA

(Address of principal executive offices)

94065

(Zip Code)

(650) 251-0005

(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 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. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

As of October 31, 2016 there were 28,765,282 shares of the registrant’s common stock, par value $0.001 per share, outstanding.

Nevro Corp.

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PART I—FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

Nevro Corp.

Condensed Consolidated Balance Sheets

(unaudited)

(in thousands, except share and per share data)

	September 30, 2016	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	$ 42,733	$ 87,036
Short-term investments	245,226	106,634
Accounts receivable, net of allowance for doubtful accounts of $678 and $122 at September 30, 2016 and December 31, 2015, respectively	40,837	22,522
Inventories	73,367	62,430
Prepaid expenses and other current assets	6,776	4,009
Total current assets	408,939	282,631
Property and equipment, net	7,607	5,794
Other assets	2,409	1,852
Restricted cash	906	906
Total assets	$ 419,861	$ 291,183
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$ 13,105	$ 21,887
Accrued liabilities	21,383	14,381
Other current liabilities	77	121
Total current liabilities	34,565	36,389
Long-term debt	136,496	19,740
Other long-term liabilities	1,071	462
Total liabilities	172,132	56,591
Commitments and contingencies (Note 5)		
Stockholders' equity		
Preferred stock, $0.001 par value, 10,000,000 shares authorized at September 30, 2016 and December 31, 2015; zero shares issued and outstanding at September 30, 2016 and December 31, 2015	—	—
Common stock, $0.001 par value, 290,000,000 shares authorized at September 30, 2016 and December 31, 2015; 28,611,806 and 28,143,573 shares issued and	29	28

outstanding at September 30, 2016 and December 31, 2015, respectively		
Additional paid-in capital	459,978	424,147
Accumulated other comprehensive loss	(917)	(175)
Accumulated deficit	(211,361)	(189,408)
Total stockholders’ equity	247,729	234,592
Total liabilities and stockholders’ equity	$ 419,861	$ 291,183

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

Nevro Corp.

Condensed Consolidated Statements of Operations and Comprehensive Loss

(unaudited)

(in thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$60,922	$15,402	$157,973	$36,482
Cost of revenue	19,235	5,968	53,741	15,349
Gross profit	41,687	9,434	104,232	21,133
Operating expenses				
Research and development	7,923	5,247	22,453	15,508
Sales, general and administrative	35,636	21,896	98,591	54,848
Total operating expenses	43,559	27,143	121,044	70,356
Loss from operations	(1,872)	(17,709)	(16,812)	(49,223)
Interest income	556	185	1,066	399
Interest expense	(2,381)	(739)	(3,995)	(2,093)
Other income (expense), net	259	(922)	96	(1,757)
Loss on extinguishment of debt	—	—	(1,268)	—
Loss before income taxes	(3,438)	(19,185)	(20,913)	(52,674)
Provision for income taxes	448	269	1,040	566
Net loss	(3,886)	(19,454)	(21,953)	(53,240)
Other comprehensive loss:				
Changes in foreign currency translation adjustment	(100)	(188)	(446)	(191)
Changes in unrealized losses on short-term investments, net	(507)	(89)	(296)	(4)
Net change in other comprehensive loss	(607)	(277)	(742)	(195)
Comprehensive Loss	$(4,493)	$(19,731)	$(22,695)	$(53,435)
Net loss per share, basic and diluted	$(0.14)	$(0.70)	$(0.77)	$(2.04)
Weighted average number of common shares used to compute basic and diluted net loss per share	28,542,760	27,861,523	28,373,430	26,102,679

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

Nevro Corp.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Nine Months Ended September 30, 2016	2015
Cash flows from operating activities		
Net loss	$(21,953)	$(53,240)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	1,234	287
Stock-based compensation expense	10,428	5,083
Accretion of discount on short-term investments	(148)	(324)
Non-cash loss on extinguishment of debt	1,156	—
Payment of original issue discount	(1,500)	—
Provision for doubtful accounts	562	58
Write-down of inventory	2,759	2,071
Non-cash interest expense	2,037	179
Unrealized losses on foreign currency transactions	939	—
Changes in operating assets and liabilities		
Accounts receivable	(19,249)	(4,338)
Inventories	(13,997)	(29,542)
Prepaid expenses and other current assets	(2,837)	(646)
Other assets	(557)	(1,483)
Accounts payable	(8,928)	7,994
Accrued liabilities	6,583	3,851
Other long-term liabilities	610	41
Net cash used in operating activities	(42,861)	(70,009)
Cash flows from investing activities		
Purchases of short-term investments	(266,839)	(127,924)
Proceeds from maturity of short-term investments	128,100	144,772
Changes in restricted cash	—	(606)
Purchases of property and equipment	(2,414)	(4,310)
Net cash provided by (used in) investing activities	(141,153)	11,932
Cash flows from financing activities		
Proceeds from issuance of common stock in underwritten public offering	—	118,440
Proceeds from issuance of convertible notes	172,500	—
Convertible notes initial issuance discount and debt issuance costs	(6,171)	—
Proceeds from issuance of warrants	33,120	—
Purchase of convertible note hedges	(45,092)	—
Repayment of debt	(19,500)	—
Proceeds from issuance of common stock from stock option exercises	5,234	2,145
Net cash provided by financing activities	140,091	120,585
Effect of exchange rate changes on cash and cash equivalents	(380)	(237)
Net increase (decrease) in cash and cash equivalents	(44,303)	62,271

Cash and cash equivalents		
Cash and cash equivalents at beginning of period	87,036	25,287
Cash and cash equivalents at end of period	$42,733	$87,558
Significant non-cash transactions		
Purchases of property and equipment in accounts payable	$1,385	$1,016
Vesting of early-exercised stock options	$40	$39

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

Nevro Corp.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Formation and Business of the Company

Nevro Corp. (the Company) was incorporated in Minnesota on March 10, 2006 to manufacture and market innovative active implantable medical devices for the treatment of neurological disorders initially focusing on the treatment of chronic pain. Subsequently, the Company was reincorporated in Delaware on October 4, 2006 and relocated to California.

Since inception, the Company has incurred net losses and negative cash flows from operations. During the year ended December 31, 2015, the Company incurred a net loss of $67.4 million and used $100.4 million of cash in operations. For the nine months ended September 30, 2016, the Company incurred a net loss of $22.0 million and used $42.9 million of cash in operations. At September 30, 2016 and December 31, 2015, the Company had an accumulated deficit of $211.4 million and $189.4 million, respectively. The Company has financed operations to date primarily through private placements of equity securities, borrowings under a debt agreement, the issuance of common stock in its November 2014 initial public offering, its June 2015 underwritten public offering and its June 2016 underwritten public offering of convertible senior notes due 2021. The Company's ability to continue to meet its obligations and to achieve its business objectives for the foreseeable future is dependent upon, amongst other things, generating sufficient revenues and its ability to continue to control expenses. Failure to increase sales of its products, manage discretionary expenditures or raise additional financing, if required, may adversely impact the Company's ability to achieve its intended business objectives.

The accompanying interim condensed consolidated financial statements as of September 30, 2016 and for the nine months ended September 30, 2016 and 2015, and the related interim information contained within the notes to the financial statements, are unaudited. The unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP) for interim financial information and on the same basis as the audited financial statements filed included on the Company's Annual Report on Form 10-K (Annual Report) filed with the Securities and Exchange Commission (SEC) on February 29, 2016. In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to state fairly the Company's financial position as of September 30, 2016, and the results of its operations and cash flows for the nine months ended September 30, 2016 and 2015. All such adjustments are of a normal and recurring nature. The interim financial data as of September 30, 2016 is not necessarily indicative of the results to be expected for the year ending December 31, 2016, or for any future period.

The accompanying condensed consolidated financial statements and related financial information should be read in conjunction with the audited consolidated financial statements and the related notes thereto for the year ended December 31, 2015 included in the Annual Report.

2. Summary of Significant Accounting Policies

Basis of Presentation

These condensed consolidated financial statements have been prepared in accordance with U.S. GAAP. The condensed consolidated financial statements include the Company's accounts and those of its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Segments

The chief operating decision maker for the Company is the Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region, for purposes of allocating resources and evaluating financial performance. The Company has one business activity and there are no segment managers who are held accountable for operations, operating results or plans for levels or components below the consolidated unit level. Accordingly, the Company has determined that it has a single reportable and operating segment structure. The Company and its Chief Executive Officer evaluate performance based primarily on revenue in the geographic locations in which the Company operates.

Historically, the Company derived most of its revenue from sales to customers in Australia and Europe. In May 2015, the U.S. Food and Drug Administration (FDA) approved the Company's premarket approval (PMA) application to market Senza in the United States and the Company launched sales in the United States in 2015. Revenue by geography is based on the billing address of the customer. The following table sets forth, by geographic area, those countries with revenue accounting for more than 10% of the total revenue in any of the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
United States	78 %	29 %	74 %	12 %
Australia	*	24 %	*	27 %
United Kingdom	*	15 %	*	17 %
Germany	*	14 %	*	17 %

* Represents less than 10%

Long-lived assets located outside the United States are not material; therefore, disclosures have been limited to revenue.

Foreign Currency Translation

The Company's consolidated financial statements are prepared in U.S. dollars (USD). Its foreign subsidiaries use their local currency as their functional currency and maintain their records in the local currency. Accordingly, the assets and liabilities of these subsidiaries are translated into USD using the current exchange rates in effect at the balance sheet date and equity accounts are translated into USD using historical rates. Revenues and expenses are translated using the monthly average exchange rates during the period when the transaction occurs. The resulting foreign currency translation adjustments from this process are recorded in accumulated other comprehensive income (loss) on the consolidated balance sheets.

Unrealized foreign exchange gains and losses from the remeasurement of assets and liabilities denominated in currencies other than the functional currency of the reporting entity are recorded in other income (expense), net. Additionally, realized gains and losses resulting from transactions denominated in currencies other than the local currency are recorded in other income (expense), net in the condensed consolidated statements of operations. The Company recorded net unrealized and net realized foreign currency transaction gains (losses) during the periods presented as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net unrealized foreign currency gains (losses)	$615	$293	$(663)	$958
Net realized foreign currency gains (losses)	(310)	(1,170)	918	(2,576)

As the Company's international operations grow, its risks associated with fluctuations in currency rates will become greater, and the Company will continue to reassess its approach to managing this risk. In addition, currency fluctuations or a weakening USD can increase the costs of the Company's international expansion. To date, the Company has not entered into any foreign currency hedging contracts. Based on its current international structure, the

Company does not plan on engaging in hedging activities in the near future.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Significant accounting estimates and management judgments reflected in the condensed consolidated financial statements include items such as allowances for doubtful accounts; clinical accruals; stock-based compensation; depreciation and amortization periods; inventory valuation; and valuation of investments and deferred tax assets, including valuation allowances. Estimates are based on historical experience, where applicable, and other assumptions believed to be reasonable by the management. Actual results may differ from those estimates under different assumptions or conditions.

Concentration of Credit Risk and Other Risks and Uncertainties

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and investments. The majority of the Company's cash is held by one financial institution in the United States in excess of federally insured limits. The Company maintained investments in money market funds that were not federally insured during the periods ended September 30, 2016 and December 31, 2015. The Company also held cash in foreign banks of approximately $4.0 million at September 30, 2016 and $5.2 million at December 31, 2015 that was not federally insured. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Through December 31, 2014, all of the Company's revenue had been derived from sales of its products in international markets, principally Australia and Europe. In May 2015, the Company launched sales in the United States upon receiving FDA approval to market and sell its products in the United States. In the international markets in which the Company participates, the Company uses both a direct sales force and distributors to sell its products, while in the United States the Company utilizes a direct sales force. The Company performs ongoing credit evaluations of its direct customers and distributors, does not require collateral, and maintains allowances for potential credit losses on customer accounts when deemed necessary.

During the three and nine months ended September 30, 2016 and 2015, no single customer accounted for more than 10% of the Company's revenue. As of September 30, 2016 and December 31, 2015, no single customer accounted for more than 10% of the accounts receivable balance.

The Company is subject to risks common to medical device companies, including, but not limited to, new technological innovations, dependence on key personnel, protection of proprietary technology, compliance with government regulations, product liability, manufacturing quality and scaling, continued reimbursement from third-party payors, uncertainty of market acceptance of products and the need to obtain additional financing. The Company is dependent on third-party manufacturers and suppliers, in some cases sole- or single-source suppliers.

There can be no assurance that the Company's products or services will continue to be accepted in its existing marketplaces, nor can there be any assurance that any future products or services can be developed or manufactured at an acceptable cost and with appropriate performance characteristics, or that such products or services will be successfully marketed, if at all.

The Company may choose to raise additional funds to further enhance its research and development efforts, for product expansion opportunities or to acquire a new business or products that are complementary to its business. There can be no assurance that such financing will be available or will be at terms acceptable by the Company.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's financial instruments, including cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities.

Cash and Cash Equivalents

The Company considers all highly-liquid investments purchased with an original maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents include money market funds in the amount of $24.2 million and $36.6 million as of September 30, 2016 and December 31, 2015, respectively. At September 30, 2016 and December 31, 2015, the Company's cash equivalents were held at institutions in the United States and include deposits in a money market fund which was unrestricted as to withdrawal or use.

Restricted Cash

Restricted cash as of September 30, 2016 and December 31, 2015 consists of a letter of credit of $0.6 million representing collateral for the Company's Redwood City, California building lease pursuant to an agreement dated March 5, 2015 and certificates of deposit of $0.3 million collateralizing payment of charges related to the Company's credit cards.

Investment Securities

The Company classifies its investment securities as available-for-sale. Those investments with maturities of less than 12 months at the date of purchase are considered short-term investments. Those investments with maturities greater than 12 months at the date of purchase are considered long-term investments. The Company's investment securities classified as available-for-sale are recorded at fair value. Unrealized gains and losses, deemed temporary in nature, are reported as a separate component of accumulated comprehensive income (loss).

A decline in the fair value of any security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Premiums (discounts) are amortized (accreted) over the life of the related security as an adjustment to yield using the straight-line interest method. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Inventories

Inventories are stated at the lower of cost to purchase or manufacture the inventory or the market value of such inventory. Cost is determined using the standard cost method which approximates the first-in, first-out basis. Market value is determined as the lower of replacement cost or net realizable value. The Company regularly reviews inventory quantities in consideration of actual loss experiences, projected future demand and remaining shelf life to record a provision for excess and obsolete inventory when appropriate.

The Company writes down inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value, and inventory that is in excess of expected requirements. The estimate of excess quantities is subjective and primarily dependent on the Company's estimates of future demand for a particular product. If the estimate of future demand is inaccurate based on actual sales, the Company may increase the write down for excess inventory for that component and record a charge to inventory impairment in the accompanying consolidated statements of operations and comprehensive loss. The Company periodically evaluates the carrying value of inventory on hand for potential excess amounts over demand using the same lower of cost or market approach that has been used to value inventory. The Company also periodically evaluates inventory quantities in consideration of actual loss experience. In addition, the Company determines at times that there may be certain inventory that does not meet its product requirements. As a result of these evaluations, the Company recognized total write downs of $1.1 million and $0.5 million for its inventories for the three months ended September 30, 2016 and 2015, respectively, and $2.8 million and $2.1 million for the nine months ended September 30, 2016 and 2015, respectively. The Company's estimation of the future demand for a particular component of the Senza product may vary and may result in changes in estimates of inventory values in any particular period.

Shipping and Handling Costs

Shipping and handling costs are expensed as incurred and are included in cost of revenue.

Revenue Recognition

The Company recognizes revenue when all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- the sales price is fixed or determinable;
- collection of the relevant receivable is reasonably assured at the time of sale; and
- delivery has occurred or services have been rendered.

For a majority of sales, where the Company's sales representative delivers its product at the point of implantation at hospitals or medical facilities, the Company recognizes revenue upon completion of the procedure and authorization, which represents satisfaction of the required revenue recognition criteria. For the remaining sales, which are sent from the Company's distribution centers directly to hospitals and medical facilities, as well as distributor sales, where product is ordered in advance of an implantation procedure and a valid purchase order has been received, the Company recognizes revenue at the time of shipment of the product, which represents the point in time when the customer has taken ownership and assumed the risk of loss and the required revenue recognition criteria are satisfied. The Company's customers are obligated to pay within specified terms regardless of when or if they ever sell or use the products. The Company does not offer rights of return or price protection and it has no post-delivery obligations.

The Company has a limited one to five year warranty to most customers in the markets in which it operates. Estimated warranty obligations are recorded at the time of sale, and warranty costs have not been material to date.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation of property and equipment, other than leasehold improvements, is computed using the straight-line method over the assets' estimated useful lives of three to five years. Leasehold improvements are amortized on a straight-line basis over the shorter of the estimated useful life of the asset or the life of the lease. Upon retirement or sale, the cost and related accumulated depreciation are removed from the consolidated balance sheet and the resulting gain or loss, if any, is reflected in operations. Maintenance and repairs are charged to operations as incurred.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. When such an event occurs, management determines whether there has been impairment by comparing the anticipated undiscounted future net cash flows to the related asset group's carrying value. If an asset is considered impaired, the asset is written down to fair value, which is based either on discounted cash flows or appraised value, depending on the nature of the asset. There were no impairment charges or changes in estimated useful lives recorded through September 30, 2016.

Income Taxes

During the three and nine months ended September 30, 2016 and 2015, the Company calculated its interim tax provision to record taxes incurred on a discrete basis due to the variability of taxable income in the jurisdictions in which it operates. Additionally, the Company records income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's condensed consolidated financial statements or income tax returns. In estimating future tax consequences, expected future events other than enactments or changes in the tax law or rates are considered. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes for the three and nine months ended September 30, 2016 and 2015 is primarily comprised of foreign taxes based upon income earned during the period with no tax benefit recorded for the loss jurisdictions.

The Company operates in various tax jurisdictions and is subject to audit by various tax authorities. To date, taxes paid have been predominantly due to income taxes in foreign jurisdictions in which the Company conducts business. The Company provides for tax contingencies whenever it is deemed probable that a tax asset has been impaired or a tax liability has been incurred for events such as tax claims or changes in tax laws. Tax contingencies are based upon their technical merits, relative tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax contingencies.

The Company records uncertain tax positions on the basis of a two-step process whereby (1) a determination is made as to whether it is more likely than not that the tax positions will be sustained based on the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, the Company recognizes the largest amount of tax benefit that is greater than 50% likely to be realized upon ultimate settlement with the related tax authority. The Company's policy is to recognize interest and penalties related to income taxes as a component of income tax expense. No interest or penalties related to income taxes have been recognized in the statements of operations and comprehensive loss for the three and nine months ended September 30, 2016 and 2015.

Comprehensive Income (Loss)

Comprehensive income (loss) represents all changes in the stockholders' equity except those resulting from and distributions to stockholders. The Company's changes in unrealized gains and losses on available-for-sale investment securities and foreign currency translation adjustments represent the components of other comprehensive income (loss) that are excluded from the reported net loss and have been presented in the consolidated statements of operations and comprehensive loss.

Research and Development

Research and development costs, including new product development, regulatory compliance and clinical research, are charged to operations as incurred in the consolidated statements of operations and comprehensive loss. Such costs include personnel-related costs, including stock-based compensation, supplies, services, depreciation, allocated facilities and information services, clinical trial and related clinical manufacturing expenses, fees paid to investigative sites and other indirect costs.

Stock-Based Compensation

The Company accounts for stock-based compensation arrangements with employees in accordance with Accounting Standards Codification (ASC) 718, Compensation - Stock Compensation. ASC 718 requires the recognition of compensation expense, using a fair value-based method, for costs related to all share-based payments including stock options.

The Company's determination of the fair value of stock options on the date of grant utilizes the Black-Scholes option-pricing model and is impacted by its common stock price as well as changes in assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected term that options will remain outstanding, expected common stock price volatility over the term of the option awards, risk-free interest rates and expected dividends.

The fair value is recognized over the period during which an optionee is required to provide services in exchange for the option award, known as the requisite service period (usually the vesting period) on a straight-line basis. Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. The Company estimates future forfeitures at the date of grant and revises the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Equity instruments issued to non-employees are recorded at their fair value on the measurement date and are subject to periodic adjustments as the underlying equity instruments vest. The fair value of options granted to consultants is expensed when vested. The non-employee stock-based compensation expense was not material for all periods presented.

Estimating the fair value of equity-settled awards as of the grant date using valuation models, such as the Black-Scholes option pricing model, is affected by assumptions regarding a number of complex variables. Changes in the assumptions can materially affect the fair value and ultimately how much stock-based compensation expense is recognized. These inputs are subjective and generally require significant analysis and judgment to develop. For all stock options granted to date, the Company estimated the volatility data based on a study of publicly traded industry peer companies. For purposes of identifying these peer companies, the Company considered the industry, stage of development, size and financial leverage of potential comparable companies. The risk-free interest rate is based on the yield available on U.S. Treasury zero-coupon issues similar in duration to the expected term of the equity-settled award.

The Company accounts for stock-based compensation for the restricted stock units at their fair value, based on the closing market price of the Company's common stock on the grant date. These costs are recognized on a straight-line basis over the requisite service period, which is generally the vesting term of four years.

The Company also issues stock options and restricted stock units with vesting based upon completion of performance goals. The fair value for these performance based awards is recognized over the period during which the goals are to be achieved. Stock-based compensation expense recognized at fair value includes the impact of estimated probability that the goals would be achieved, which is assessed prior to the requisite service period for the specific goals.

The Company recognizes a benefit from stock-based compensation as additional paid-in capital if an incremental tax benefit is realized by following the with-and-without approach.

Net Loss per Share of Common Stock

Basic net loss per common share is calculated by dividing the net loss by the weighted average number of common shares outstanding during the period, without consideration for potentially dilutive securities. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common shares and potentially dilutive securities outstanding for the period. For purposes of the diluted net loss per share calculation, the Company's restricted stock units and common stock options are considered to be potentially dilutive securities. Because the Company has reported a net loss in all periods presented, diluted net loss per common share is the same as basic net loss per common share for those periods.

Recent Accounting Pronouncements

In July 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory, which permits companies to measure inventory at the lower of cost and realizable value. ASU 2015-11 applies to all business entities and is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. Early adoption is permitted. The Company has not determined the potential effects of ASU 2015-11 on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements in ASC 605, Revenue Recognition. This ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which effectively delayed the adoption date by one year, to an effective date for public entities for annual and interim periods beginning after December 15, 2017. In April 2016, FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, which clarifies the aspects of Topic 606 that relates to identifying performance obligations and licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, related to disclosures of remaining performance obligations, as well as other amendments to guidance on collectability, non-cash consideration and the presentation of sales and other similar taxes collected from customers. The effective dates of ASU 2016-10 and ASU 2016-12 are the same as that of ASU 2014-09. The Company has not determined the potential effects of the guidance on its consolidated financial statements, nor has it selected the transition method.

In August 2014, the FASB issued ASU No. 2014-15, Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern. The new standard provides guidance around management’s responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The new standard is effective for fiscal years, and interim periods within those fiscal years, ending after December 15, 2016. Early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company has not determined the potential effects of this ASU on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This update requires an entity to recognize assets and liabilities for leases with lease terms of more than 12 months on the balance sheet. ASU 2016-02 is effective for public entities for fiscal years beginning after December 15, 2018. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This update simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for public entities for annual periods beginning after December 15, 2016. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This update changes the accounting for recognizing impairments of financial assets, such that credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. ASU 2016-13 is effective for public entities for annual periods beginning after December 15, 2019. Early adoption is permitted after December 15, 2018. The Company has not determined the potential effects of this ASU on its consolidated financial statements.

In August, 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force). The update clarifies the classification of certain cash receipts and cash payments in the statement of cash flows, including debt prepayment or extinguishment costs, settlement of contingent consideration arising from a business combination, insurance settlement proceeds and distributions from certain equity method investees. ASU 2016-15 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory. This update is intended to reduce the complexity and diversity in practice related to the tax consequences of certain types of intra-entity asset transfers. Under this ASU, a selling entity is required to recognize a current tax expense or benefit upon the transfer of the asset. Similarly, the purchasing entity is required to recognize a deferred tax asset or liability, as well as the related deferred tax benefit or expense, upon receipt of the asset. This ASU does not apply to intra-entity transfers of inventory, where the income tax consequences from the sale of inventory from one member of a consolidated entity to another will continue to be deferred until the inventory is sold to a third party. ASU 2016-16 is effective for public entities for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

3. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or an exit price paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value hierarchy defines a three-level valuation hierarchy for disclosure of fair value measurements as follows:

- Level 1—Observable inputs, such as quoted prices in active markets for identical assets or liabilities.
- Level 2—Observable inputs other than Level 1 prices, 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 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Cash Equivalents and Short-Term Investments

The Company's cash equivalents are comprised of investments in money market funds that are classified as Level 1 of the fair value hierarchy and commercial paper and corporate notes that are classified as Level 2 in the fair value hierarchy. To value its money market funds, the Company values the funds at $1 stable net asset value, which is the market pricing convention for identical assets that the Company has the ability to access. The Company's short-term investments are comprised of commercial paper and U.S. government agency obligations. All short-term investments have been classified within Level 1 or Level 2 of the fair value hierarchy because of the sufficient observable inputs for revaluation. The Company's Level 2 investments are valued using third-party pricing sources. The pricing services utilize industry-standard valuation models, including both income and market-based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trades of and broker/dealer quotes on the same or similar investments, issuer credit spreads, benchmark investments, prepayment/default projections based on historical data and other observable inputs. The following table sets forth the Company's financial instruments that were measured at fair value on a recurring basis by level within the fair value hierarchy (in thousands):

Balance as of September 30, 2016	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$24,185	$—	$ —	$24,185
Commercial paper (iii)	—	171,258	—	171,258
Corporate notes (iii)	—	73,969	—	73,969
Total assets	$24,185	$245,227	$ —	$269,412

Balance as of December 31, 2015	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$36,559	$—	$ —	$36,559
Commercial paper (ii)	—	129,206	—	129,206
Treasury bonds (iii)	10,617	—	—	10,617
Total assets	$47,176	$129,206	$ —	$176,382

(i) Included in cash and cash equivalents on the condensed consolidated balance sheets.
(ii) Included in either cash and cash equivalents or short-term investments on the condensed consolidated balance sheets.
(iii) Included in short-term investments on the condensed consolidated balance sheets.

Convertible Senior Notes

As of September 30, 2016, the fair value of the 1.75% convertible senior notes due 2021 was $225.1 million. The fair value was determined on the basis of market prices observable for similar instruments and is considered Level 2 in the fair value hierarchy (See Note 6).

4. Balance Sheet Components

Investments

The fair value of the Company's cash equivalents and short-term investments approximates their respective carrying amounts due to their short-term maturity. The following is a summary of the gross unrealized gains and unrealized losses on the Company's investment securities, excluding investments in money market funds (in thousands):

	September 30, 2016			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper	$ 171,352	$ 9	$ (103)	$ 171,258
Corporate notes	74,039	2	(72)	73,969
Total securities	$ 245,391	$ 11	$ (175)	$ 245,227

	December 31, 2015			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper (i)	$ 129,075	$ 131	$ —	$ 129,206
Treasury bonds	10,616	1	—	10,617
Total securities	$ 139,691	$ 132	$ —	$ 139,823

(i) Included $33.2 million of commercial paper that is classified as cash and cash equivalents on the consolidated balance sheet.

Realized gains or losses and other-than-temporary impairments, if any, on available-for-sale securities are reported in other income (expense), net as incurred. The cost of securities sold is determined based on the specific identification method. The Company has not recorded any realized gains or losses on its investments during the periods presented.

The contractual maturities of the Company's investment securities were all within one year as of September 30, 2016 and December 31, 2015.

Inventories (in thousands)

	September 30, 2016	December 31, 2015