

INSULET CORP  
Form 10-Q  
November 07, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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Form 10-Q

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

For the quarterly period ended September 30, 2013  
OR

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

Commission File Number 001-33462

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INSULET CORPORATION  
(Exact name of Registrant as specified in its charter)

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Delaware (State or Other Jurisdiction of Incorporation or Organization)	04-3523891 (I.R.S. Employer Identification No.)
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9 Oak Park Drive Bedford, Massachusetts (Address of Principal Executive Offices)	01730 (Zip Code)
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Registrant's Telephone Number, Including Area Code: (781) 457-5000

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

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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 November 1, 2013, the registrant had 54,539,340 shares of common stock outstanding.

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## PART I — FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements  
INSULET CORPORATION  
CONSOLIDATED BALANCE SHEETS

	As of September 30, 2013 (Unaudited) (In thousands, except share and per share data)	As of December 31, 2012
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 153,905	\$ 57,293
Accounts receivable, net	34,465	33,294
Inventories	5,395	14,867
Prepaid expenses and other current assets	5,921	4,482
Total current assets	199,686	109,936
Property and equipment, net	31,399	25,422
Intangible assets, net	19,154	22,963
Goodwill	37,536	37,536
Other assets	1,721	2,202
Total assets	\$ 289,496	\$ 198,059
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities		
Accounts payable	\$ 15,117	\$ 9,361
Accrued expenses and other current liabilities	30,017	19,051
Deferred revenue	567	5,445
Current portion of capital lease obligations	2,593	—
Current portion of long-term debt	—	14,429
Total current liabilities	48,294	48,286
Capital lease obligations	6,092	—
Long-term debt	111,117	103,730
Other long-term liabilities	2,567	1,867
Total liabilities	168,070	153,883
Commitments and contingencies (Note 11)		
Stockholders' Equity		
Preferred stock, \$.001 par value:		
Authorized: 5,000,000 shares at September 30, 2013 and December 31, 2012	—	—
Issued and outstanding: zero shares at September 30, 2013 and December 31, 2012	—	—
Common stock, \$.001 par value:		
Authorized: 100,000,000 shares at September 30, 2013 and December 31, 2012		
Issued and outstanding: 54,521,310 and 48,359,063 shares at September 30, 2013 and 55 December 31, 2012, respectively		48
Additional paid-in capital	645,396	525,679
Accumulated deficit	(524,025	) (481,551 )
Total stockholders' equity	121,426	44,176
Total liabilities and stockholders' equity	\$ 289,496	\$ 198,059

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

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CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30, 2013		2012		Nine Months Ended September 30, 2013		2012	
	(Unaudited)							
	(In thousands, except share and per share data)							
Revenue	\$61,103		\$54,752		\$178,551		\$153,541	
Cost of revenue	33,708		30,362		99,168		86,524	
Gross profit	27,395		24,390		79,383		67,017	
Operating expenses:								
Research and development	5,771		6,559		15,341		18,512	
General and administrative	23,530		12,731		50,525		38,416	
Sales and marketing	15,407		13,571		42,858		39,974	
Total operating expenses	44,708		32,861		108,724		96,902	
Operating loss	(17,313	)	(8,471	)	(29,341	)	(29,885	)
Interest income	27		31		91		83	
Interest and other expense	(3,999	)	(3,949	)	(12,970	)	(11,728	)
Other expense, net	(3,972	)	(3,918	)	(12,879	)	(11,645	)
Loss before income taxes	(21,285	)	(12,389	)	(42,220	)	(41,530	)
Income tax expense	(5	)	(28	)	(254	)	(143	)
Net loss	\$(21,290	)	\$(12,417	)	\$(42,474	)	\$(41,673	)
Net loss per share basic and diluted	\$(0.39	)	\$(0.26	)	\$(0.79	)	\$(0.87	)
Weighted-average number of shares used in calculating net loss per share	54,458,364		48,041,392		53,786,974		47,825,136	

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2013	2012
	(Unaudited)	
	(In thousands)	
Cash flows from operating activities		
Net loss	\$(42,474	) \$(41,673
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	8,859	8,092
Non-cash interest and other expense	8,726	7,556
Stock-based compensation expense	9,800	7,500
Provision for bad debts	3,942	2,321
Impairment and other charges	2,511	—
Changes in operating assets and liabilities:		
Accounts receivable	(5,113	) (9,276
Inventories	9,472	(3,251
Deferred revenue	(4,878	) (1,444
Prepaid expenses and other assets	(1,401	) (1,966
Accounts payable, accrued expenses and other current liabilities	16,722	8,657
Other long-term liabilities	700	18
Net cash provided by (used in) operating activities	6,866	(23,466
Cash flows from investing activities		
Purchases of property and equipment	(4,517	) (8,936
Net cash used in investing activities	(4,517	) (8,936
Cash flows from financing activities		
Payments for capital lease obligations	(336	) —
Repayment of debt	(2,000	) —
Net proceeds from issuance of common stock	99,164	3,142
Payment of withholding taxes in connection with vesting of restricted stock units	(2,565	) (1,252
Net cash provided by financing activities	94,263	1,890
Net increase (decrease) in cash and cash equivalents	96,612	(30,512
Cash and cash equivalents, beginning of period	57,293	93,955
Cash and cash equivalents, end of period	\$153,905	\$63,443
Non-cash investing and financing activities		
Common stock issued in exchange for 5.375% Convertible Senior Notes	\$13,000	\$—
Purchases of property and equipment under capital lease	\$9,021	\$—

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

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INSULET CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Nature of the Business

The Company is primarily engaged in the development, manufacturing and sale of its proprietary OmniPod Insulin Management System (the “OmniPod System”), an innovative, discreet and easy-to-use insulin infusion system for people with insulin-dependent diabetes. The OmniPod System is the only commercially-available insulin infusion system of its kind. The OmniPod System features a unique disposable tubeless OmniPod which is worn on the body for approximately three days at a time and the handheld, wireless Personal Diabetes Manager (“PDM”). Conventional insulin pumps require people with insulin-dependent diabetes to learn to use, manage and wear a number of cumbersome components, including up to 42 inches of tubing. In contrast, the OmniPod System features two discreet, easy-to-use devices that eliminate the need for a bulky pump, tubing and separate blood glucose meter, provides for virtually pain-free automated cannula insertion, communicates wirelessly and integrates a blood glucose meter. In June 2011, the Company acquired Neighborhood Holdings, Inc. and its wholly-owned subsidiaries (collectively, “Neighborhood Diabetes”) in order to support the sales of the OmniPod System, expand the Company’s full suite diabetes management product offerings and obtain access to a larger number of insulin dependent patients. Through Neighborhood Diabetes, the Company is able to provide customers with blood glucose testing supplies, traditional insulin pumps, pump supplies and pharmaceuticals and has the ability to process claims as either durable medical equipment or through pharmacy benefits.

The Company began commercial sale of the OmniPod System in the United States in October 2005. The Company has also expanded the availability of the OmniPod System internationally through its partnership with Ypsomed Distribution AG (“Ypsomed”) and GlaxoSmithKline (“GSK”). In January 2010, the Company entered into a distribution agreement with Ypsomed pursuant to which Ypsomed became the exclusive distributor of the OmniPod System in multiple countries. In February 2011, the Company entered into a distribution agreement with GSK pursuant to which GSK became the exclusive distributor of the OmniPod System in Canada.

In August 2011, the Company received CE Mark approval, and in December 2012 the Company received 510(k) clearance by the FDA for its new OmniPod System. The new OmniPod System is more than one-third smaller and one-quarter lighter than the original model, while maintaining the same features and operating capabilities. The Company began selling the new OmniPod System in certain countries in Europe through Ypsomed in 2012. The Company began selling the new OmniPod System to new customers in the U.S. during the first quarter of 2013 and began converting the existing customer base in the second quarter of 2013. By the end of the third quarter, the Company completely transitioned its production to the new OmniPod System.

2. Summary of Significant Accounting Policies

Basis of Presentation

The unaudited consolidated financial statements in this Quarterly Report on Form 10-Q have been prepared in accordance with generally accepted accounting principles (“GAAP”) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, these unaudited consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2013, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2013, or for any other subsequent interim period.

The unaudited consolidated financial statements in this Quarterly Report on Form 10-Q should be read in conjunction with the Company’s consolidated financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

Use of Estimates in Preparation of Financial Statements

The preparation of 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 at the date of the financial statements, and the reported amounts of revenue and expense during the reporting periods.

The most significant estimates used in these financial statements include the valuation of stock-based compensation expense, accounts receivable, inventories, goodwill, deferred revenue and equity instruments, the lives of property and equipment and intangible



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assets, as well as warranty and doubtful accounts allowance reserve calculations. Actual results may differ from those estimates.

### Principles of Consolidation

The unaudited consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of the Company and its wholly-owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

### Fair Value Measurements

The Company adopted the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 820, Fair Value Measurements and Disclosures (“ASC 820”) related to the fair value measurement of certain of its assets and liabilities. ASC 820 defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also describes three levels of inputs that may be used to measure the fair value:

Level 1 — quoted prices in active markets for identical assets or liabilities

Level 2 — observable inputs other than quoted prices in active markets for identical assets or liabilities

Level 3 — unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions

The only assets and liabilities subject to fair value measurement standards at September 30, 2013 and December 31, 2012 are cash equivalents, including money market accounts, and long-term obligations which are based on Level 1 inputs.

Certain of the Company’s financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other liabilities are carried at cost, which approximates their fair value because of the short-term maturity of these financial instruments. Based on the borrowing rates currently available to the Company for loans with similar terms, the carrying value of the Company’s long-term debt and capital lease obligations approximates their fair values.

### Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due from third-party payors, patients, third-party distributors, and government agencies. The allowance for doubtful accounts is recorded at the time collection risk is identified. The Company estimates its allowance based on historical experience, assessment of specific risk, discussions with individual customers and various assumptions and estimates that are believed to be reasonable under the circumstances.

### Inventories

Inventories are held at the lower of cost or market, determined under the first-in, first-out method. Inventory has been recorded at cost as of September 30, 2013 and December 31, 2012. Work in process is calculated based upon a build up in the stage of completion using estimated labor inputs for each stage in production. The Company periodically reviews inventories for potential impairment based on quantities on hand and expectations of future use.

### Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the estimated useful life of the respective assets. Leasehold improvements are amortized over their useful life or the life of the lease, whichever is shorter. Assets acquired under capital leases are amortized in accordance with the respective class of owned assets or life of the lease and the amortization is included with depreciation expense. Maintenance and repair costs are expensed as incurred. In the three and nine month periods ended September 30, 2013 in connection with the transition to the new OmniPod System, the Company recorded a \$2.5 million charge to expense the value of manufacturing equipment that was no longer expected to be used in its manufacturing process.

### Intangibles and Other Long-Lived Assets

The Company’s finite-lived intangible assets are stated at cost less accumulated amortization. The Company assesses its intangible and other long-lived assets for impairment whenever events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. The Company recognizes an impairment loss for intangibles and

other long-lived assets if the carrying amount of the asset is not recoverable based on its undiscounted future cash flows. Any such impairment loss is measured as the difference between the carrying amount and the fair value of the asset. The estimation of useful lives and expected cash flows requires the Company to make significant judgments regarding future periods that are subject to some

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factors outside its control. Changes in these estimates can result in significant revisions to the carrying value of these assets and may result in material charges to the results of operations. The estimated life of the acquired tradename asset is 15 years. The estimated life of the acquired customer relationship asset is 10 years. Intangible assets with determinable estimated lives are amortized over these lives. At September 30, 2013, intangible assets consisted of \$16.8 million of customer relationships and \$2.4 million of tradenames.

### Goodwill

Goodwill represents the excess of the cost of the acquired Neighborhood Diabetes businesses over the fair value of identifiable net assets acquired. The Company performs an assessment of its goodwill for impairment on at least an annual basis or whenever events or changes in circumstances indicate there might be impairment.

Goodwill is evaluated at the reporting unit level. To test for impairment, the Company compares the carrying value of the reporting unit to its fair value using a discounted cash flow analysis. If the reporting unit's carrying value exceeds its fair value, the Company would record an impairment loss to the extent that the carrying value of goodwill exceeds its implied fair value.

### Warranty

The Company provides a four-year warranty on its PDMs and may replace any OmniPods that do not function in accordance with product specifications. The Company estimates its warranty reserves at the time the product is shipped based on historical experience and the estimated cost to service the claims. Cost to service the claims reflects the current product cost, which has been decreasing over time. As these estimates are based on historical experience, and the Company continues to introduce new versions of existing products, the Company also considers the anticipated performance of the product over its warranty period in estimating warranty reserves.

### Revenue Recognition

The Company generates nearly all of its revenue from sales of its OmniPod System and other diabetes related products including blood glucose testing supplies, traditional insulin pumps, pump supplies and pharmaceuticals to customers and third-party distributors who resell the products to patients with diabetes.

Revenue recognition requires that persuasive evidence of a sales arrangement exists, delivery of goods occurs through transfer of title and risk and rewards of ownership, the selling price is fixed or determinable and collectability is reasonably assured. With respect to these criteria:

The evidence of an arrangement generally consists of a physician order form, a patient information form and, if applicable, third-party insurance approval for sales directly to patients or a purchase order for sales to a third-party distributor.

Transfer of title and risk and rewards of ownership are passed to the patient or third-party distributor upon shipment of the products.

The selling prices for all sales are fixed and agreed with the patient or third-party distributor and, if applicable, the patient's third-party insurance provider(s), prior to shipment and are based on established list prices or, in the case of certain third-party insurers, contractually agreed upon prices. Provisions for discounts and rebates to customers are established as a reduction to revenue in the same period the related sales are recorded.

The Company offers a 45-day right of return for its OmniPod System sales to new patients, and defers revenue to reflect estimated sales returns in the same period that the related product sales are recorded. Returns are estimated through a comparison of the Company's historical return data to their related sales. Historical rates of return are adjusted for known or expected changes in the marketplace when appropriate. When doubt exists about reasonable assuredness of collectability from specific customers, the Company defers revenue from sales of products to those customers until payment is received.

In June 2011, the Company entered into a development agreement with a U.S. based pharmaceutical company (the "Development Agreement"). Under the Development Agreement, the Company is required to perform design, development, regulatory and other services to support the pharmaceutical company as it works to obtain regulatory

approval to use the Company's drug delivery technology as a delivery method for its pharmaceutical. Over the term of the Development Agreement, the Company has and will continue to invoice amounts based upon meeting certain deliverable milestones. Revenue from the Development Agreement is recognized using a proportional performance methodology based on efforts

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incurred and total payments under the agreement. The impact of changes in the expected total effort or contract payments are recognized as a change in estimate using the cumulative catch-up method.

The Company deferred revenue of \$0.6 million and \$5.4 million as of September 30, 2013 and December 31, 2012, respectively. The deferred revenue recorded was comprised of product-related revenue and unrecognized amounts related to the Development Agreement.

### Concentration of Credit Risk

Financial instruments that subject the Company to credit risk primarily consist of cash and cash equivalents. The Company maintains the majority of its cash with two accredited financial institutions.

The Company purchases complete OmniPods from Flextronics International Ltd., its single source supplier. As of September 30, 2013 and December 31, 2012, liabilities to one vendor represented approximately 26% and 19% of the combined balance of accounts payable, accrued expenses, and other current liabilities, respectively.

### Segment Reporting

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated on a regular basis by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources to an individual segment and in assessing performance of the segment. The Company's current product offering consists of diabetes supplies, including the OmniPod System as well as other diabetes related products and supplies such as blood glucose testing supplies, traditional insulin pumps, pump supplies and pharmaceuticals. The Company's current product offering is marketed to a single customer type, people with diabetes. As the Company sells a single product type, management operates the business as a single entity.

### Income Taxes

Deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates that will be in effect in the years in which the differences are expected to reverse. A valuation allowance is required to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company reviews its deferred tax assets for recoverability considering historical profitability, projected future taxable income, and the expected timing of the reversals of existing temporary differences and tax planning strategies.

The Company follows the provisions of FASB ASC 740-10, Income Taxes ("ASC 740-10") on the accounting for uncertainty in income taxes recognized in its financial statements. ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In addition, ASC 740-10 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure and transition. The Company recognizes estimated interest and penalties for uncertain tax positions in income tax expense. As of September 30, 2013 interest and penalties were immaterial to the consolidated financial statements.

The Company files federal, state and foreign tax returns. These returns are generally open to examination by the relevant tax authorities from three to four years from the date they are filed. The tax filings relating to the Company's federal and state returns are currently open to examination for tax years 2010 through 2012 and 2009 through 2012, respectively. In addition, the Company has generated tax losses since its inception in 2000. These years may be subject to examination if the losses are carried forward and utilized in future years.

### Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of FASB ASC 718-10, Compensation — Stock Compensation ("ASC 718-10"), which requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Share-based payments that contain performance conditions are recognized when such conditions are probable of being achieved.

The Company uses the Black-Scholes option pricing model to determine the weighted average fair value of options granted. The Company determines the intrinsic value of restricted stock units based on the closing price of its common stock on the date of grant. The Company recognizes the compensation expense of share-based awards on a straight-line basis for awards with only service conditions and on an accelerated method for awards with performance

conditions. Compensation expense is recognized over the respective vesting periods of the awards.

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The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by the stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. The expected life of the awards is estimated based on the midpoint between the vesting date and the end of the contractual term. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of the awards. The dividend yield assumption is based on company history and expectation of paying no dividends. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Stock-based compensation expense recognized in the financial statements is based on awards that are ultimately expected to vest. The Company evaluates the assumptions used to value the awards on a quarterly basis and, if factors change and different assumptions are utilized, stock-based compensation expense may differ significantly from what has been recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense.

See Footnote 12 for a summary of the stock activity under the Company's stock-based employee compensation plan.

## Recent Accounting Pronouncements

In July 2012, the FASB issued ASU No. 2012-2 Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment (“ASU No. 2012-2”). ASU No. 2012-2 gives a company the option to first assess qualitative factors to determine whether it is more-likely-than-not that the indefinite-lived intangible is impaired. Qualitative factors include related events and circumstances that could affect the significant inputs used in determining the fair value of the indefinite-lived intangible asset. The guidance is effective in fiscal years beginning after September 15, 2012. The Company adopted the guidance in the first quarter of 2013. The adoption of the guidance did not have a material impact on the Company's financial statements.

## 3. Debt

The Company had outstanding convertible debt and related deferred financing costs on its consolidated balance sheet as follows (in thousands):

	As of September 30, 2013	December 31, 2012
Principal amount of the 5.375% Convertible Senior Notes	\$—	\$15,000
Principal amount of the 3.75% Convertible Senior Notes	143,750	143,750
Unamortized discount	(32,633	) (40,591
Total long-term debt	111,117	118,159
Current portion of debt	—	14,429
Long-term debt	\$111,117	\$103,730
Deferred financing costs	\$1,560	\$2,004

Interest and other expense related to the 5.375% Notes (as defined below) and the 3.75% Notes (as defined below) was included in interest and other expense on the consolidated statements of operations as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Contractual coupon interest	\$1,347	\$1,549	\$4,356	\$4,647
Accretion of debt discount	2,447	2,420	7,958	7,111
Loss on debt extinguishment	—	—	325	—
Amortization of debt issuance costs	146	148	443	445
Total interest and other expense	\$3,940	\$4,117	\$13,082	\$12,203





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5.375% Convertible Senior Notes

In June 2008, the Company sold \$85 million in principal amount of 5.375% Convertible Senior Notes due June 15, 2013 (the "5.375% Notes") in a private placement to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended. The interest rate on the notes was 5.375% per annum on the principal amount from June 16, 2008, payable semi-annually in arrears in cash on December 15 and June 15 of each year. The 5.375% Notes were convertible into the Company's common stock at an initial conversion rate of 46.8467 shares of common stock per \$1,000 principal amount of the 5.375% Notes, which is equivalent to a conversion price of approximately \$21.35 per share, representing a conversion premium of 34% to the last reported sale price of the Company's common stock on the NASDAQ Global Market on June 10, 2008, subject to adjustment under certain circumstances, at any time beginning on March 15, 2013 or under certain other circumstances and prior to the close of business on the business day immediately preceding the final maturity date of the notes. The 5.375% Notes were convertible for cash up to their principal amount and shares of the Company's common stock for the remainder of the conversion value in excess of the principal amount.

The Company recorded a debt discount of \$26.9 million to equity to reflect the value of its nonconvertible debt borrowing rate of 14.5% per annum. This debt discount was amortized as non-cash interest expense over the five year term of the 5.375% Notes. The Company incurred deferred financing costs related to this offering of approximately \$3.5 million, of which \$1.1 million has been reclassified as an offset to the value of the amount allocated to equity. The remainder was recorded as other assets in the consolidated balance sheet and was amortized as non-cash interest expense over the five year term of the 5.375% Notes.

In June 2011, in connection with the issuance of \$143.8 million in principal amount of 3.75% Convertible Notes due June 15, 2016 (the "3.75% Notes"), the Company repurchased \$70 million in principal amount of the 5.375% Notes for \$85.1 million, a 21.5% premium on the principal amount. The investors that held the \$70 million in principal amount of repurchased 5.375% Notes purchased \$59.5 million in principal amount of the 3.75% Notes and retained approximately \$13.5 million in principal amount of the remaining 5.375% Notes. These investors' combined \$73.0 million in principal amount of convertible debt (\$13.5 million of 5.375% Notes and \$59.5 million of 3.75% Notes) was considered to be a modification of a portion of the 5.375% Notes. See "3.75% Convertible Senior Notes" below for additional detail on the modification accounting.

In May 2013, the Company entered into an Exchange Agreement with a holder of its 5.375% Notes. Under the Exchange Agreement, the Company purchased \$13 million in principal amount of the 5.375% Notes in exchange for 620,122 shares of the Company's common stock and a cash payment of \$0.3 million, representing the accrued and unpaid interest. Furthermore, the Company recorded a loss on extinguishment of debt of \$0.3 million which was included in interest and other expense in the nine months ended September 30, 2013.

In June 2013, the Company repaid the remaining outstanding principal and accrued interest on the 5.375% Notes in accordance with the terms. In addition to a cash payment of \$2.1 million, representing principal and accrued and unpaid interest, the Company issued 26,523 shares of its common stock to the holders, representing the conversion value in excess of the principal amount as per the original terms of the 5.375% Notes.

No cash interest expense was recorded related to the 5.375% Notes in the three month period ended September 30, 2013. Cash interest expense related to the 5.375% Notes was \$0.2 million in the three month period ended September 30, 2012. Cash interest expense related to the 5.375% Notes was \$0.3 million and \$0.6 million in the nine month periods ended September 30, 2013 and 2012, respectively.

As of September 30, 2013, the 5.375% Notes were repaid in full and no amounts remain on the Company's balance sheet related to these notes.

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## 3.75% Convertible Senior Notes

In June 2011, the Company sold \$143.8 million in principal amount of the 3.75% Notes. The interest rate on the notes is 3.75% per annum, payable semi-annually in arrears in cash on December 15 and June 15 of each year. The 3.75% Notes are convertible into the Company's common stock at an initial conversion rate of 38.1749 shares of common stock per \$1,000 principal amount of the 3.75% Notes, which is equivalent to a conversion price of approximately \$26.20 per share, subject to adjustment under certain circumstances. The 3.75% Notes are convertible prior to March 15, 2016 only upon the occurrence of certain circumstances. On and after March 15, 2016 and prior to the close of business on the second scheduled trading day immediately preceding the final maturity date of the 3.75% Notes, the notes may be converted without regard to the occurrence of any such circumstances. The 3.75% Notes and any unpaid interest will be convertible at the Company's option for cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock for the principal amount. The Company intends to settle the principal in cash.

The Company may not redeem the 3.75% Notes prior to June 20, 2014. From June 20, 2014 to June 20, 2015 the Company may redeem the 3.75% Notes, at its option, in whole or in part, only if the last reported sale price per share of the Company's common stock has been at least 130% of the conversion price then in effect for at least 20 trading days during a period of 30 consecutive trading days. On and after June 20, 2015, the Company may redeem the 3.75% Notes, at its option (without regard to such sale price condition), in whole or in part. If a fundamental change, as defined in the Indenture for the 3.75% Notes, occurs at any time prior to maturity, holders of the 3.75% Notes may require the Company to repurchase their notes in whole or in part, for cash equal to 100% of the principal amount of the 3.75% Notes to be repurchased, plus accrued and unpaid interest. If a holder elects to convert its 3.75% Notes upon the occurrence of a make-whole fundamental change, as defined in the Indenture for the 3.75% Notes, the holder may be entitled to receive an additional number of shares of common stock on the conversion date. These additional shares are intended to compensate the holders for the loss of the time value of the conversion option and are set forth in the Indenture to the 3.75% Notes. In no event will the number of shares issuable upon conversion of a note exceed 50.5816 per \$1,000 principal amount (subject to adjustment as described in the Indenture for the 3.75% Notes). The 3.75% Notes are unsecured.

The Company identified certain features related to a portion of the 3.75% Notes, including the holders' ability to require the Company to repurchase their notes and the higher interest payments required in an event of default, which are considered embedded derivatives and should be bifurcated and accounted for at fair value. The Company assesses the value of each of these embedded derivatives at each balance sheet date. At September 30, 2013, the Company separately accounted for and determined that these derivatives had de minimus value.

In connection with the issuance of the 3.75% Notes, the Company repurchased \$70 million in principal amount of the 5.375% Notes for \$85.1 million, a 21.5% premium on the principal amount. The investors that held the \$70 million in principal amount of repurchased 5.375% Notes purchased \$59.5 million in principal amount of the 3.75% Notes and retained approximately \$13.5 million in principal amount of the remaining 5.375% Notes. This transaction was treated as a modification of a portion of the 5.375% Notes. The Company accounted for this modification of existing debt separately from the issuance of the remainder of the 3.75% Notes.

Prior to the transaction, the \$70 million in principal amount of repurchased 5.375% Notes had a debt discount of \$10.5 million. This amount remained in debt discount related to the \$73 million in principal amount of modified debt. The Company recorded additional debt discount of \$15.1 million related to the premium payment in connection with the repurchase and \$0.2 million related to the increase in the value of the conversion feature. The portion of the debt discount related to the value of the conversion feature was recorded as additional paid-in capital. The total debt discount of \$25.8 million related to the modified debt is being amortized as non-cash interest expense at the effective rate of 16.5% over the five year term of the modified debt. The Company paid transaction fees of approximately \$2.0 million related to the modification, which were recorded as interest expense at the time of the modification.

Of the \$143.8 million in principal amount of 3.75% Notes issued in June 2011, \$84.3 million in principal amount was considered to be an issuance of new debt. The Company recorded a debt discount of \$26.6 million related to the \$84.3 million in principal amount of 3.75% Notes. The debt discount was recorded as additional paid-in capital to reflect the value of its nonconvertible debt borrowing rate of 12.4% per annum. This debt discount is being amortized as

non-cash interest expense over the five year term of the 3.75% Notes. The Company incurred deferred financing costs related to this offering of approximately \$2.8 million, of which \$0.9 million has been reclassified as an offset to the value of the amount allocated to equity. The remainder is recorded as other assets in the consolidated balance sheet and is being amortized as non-cash interest expense over the five year term of the 3.75% Notes.

Cash interest expense related to the \$143.8 million in principal amount of 3.75% Notes was \$1.3 million in each of the three month periods ended September 30, 2013 and 2012. Cash interest expense related to the \$143.8 million in principal amount of 3.75% Notes was \$4.0 million in each of the nine month periods ended September 30, 2013 and 2012.

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As of September 30, 2013 the Company included \$111.1 million on its balance sheet in long-term debt related to the 3.75% Notes. The 3.75% Notes have a remaining term of 2.75 years.

#### 4. Capital Lease Obligations

In the nine months ended September 30, 2013, the Company acquired \$9.0 million of manufacturing equipment under capital leases. The \$9.0 million obligation under the capital leases will be repaid in equal monthly installments over the 36 month terms of the leases and includes principal and interest payments with an effective interest rate of 17% . In the third quarter of 2013, the Company recorded a \$2.5 million charge to expense the value of of equipment as it was no longer expected to be used in its manufacturing process. The underlying assets have been recorded at their fair value of \$6.5 million and are included in property and equipment on the Company's balance sheet as of September 30, 2013. The assets acquired under capital leases are being amortized on a straight-line basis over 5 years in accordance with the Company's policy for depreciation of manufacturing equipment. Amortization expense on assets acquired under capital leases is included with depreciation expense.

The aggregate future minimum lease payments related to these capital leases as of September 30, 2013, are as follows (in thousands):

Year Ending	Minimum Lease
December 31,	Payments
2013 (remaining)	954
2014	3,815
2015	3,815
2016	2,409
Total	\$ 10,993

The Company recorded \$0.1 million of interest expense on the capital leases in the three and nine months ended September 30, 2013.

#### 5. Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period, excluding unvested restricted common shares. Diluted net loss per share is computed using the weighted average number of common shares outstanding and, when dilutive, potential common share equivalents from options, restricted stock units and warrants (using the treasury-stock method), and potential common shares from convertible securities (using the if-converted method). Because the Company reported a net loss for the three and nine months ended September 30, 2013 and 2012, all potential common shares have been excluded from the computation of the diluted net loss per share for all periods presented, as the effect would have been anti-dilutive. Such potentially dilutive common share equivalents consist of the following:

	Three and Nine Months Ended	
	September 30,	
	2013	2012
5.375% Convertible Senior Notes	—	702,701
3.75% Convertible Senior Notes	5,487,642	5,487,642
Unvested restricted stock units	1,034,277	863,651
Outstanding options	2,130,560	2,693,936
Outstanding warrants	62,752	62,752
Total dilutive common shares	8,715,231	9,810,682

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## 6. Accounts Receivable

Accounts receivable consist of amounts due from third-party payors, patients, third-party distributors and government agencies. The Company records an allowance for doubtful accounts at the time potential collection risk is identified. The Company estimates its allowance based on historical experience, assessment of specific risk, discussions with individual customers or various assumptions and estimates that are believed to be reasonable under the circumstances. The Company believes the reserve is adequate to mitigate current collection risk.

As of September 30, 2013 accounts receivable from two customers represented 11% and 10% of gross accounts receivable. As of December 31, 2012 accounts receivable from two customers represented approximately 18% and 11% of gross accounts receivable, respectively.

The components of accounts receivable are as follows:

	As of September 30, 2013 (In thousands)	December 31, 2012
Trade receivables	\$41,762	\$39,921
Allowance for doubtful accounts	(7,297)	(6,627)
Total accounts receivable	\$34,465	\$33,294

## 7. Inventories

Inventories consist of the following:

	As of September 30, 2013 (In thousands)	December 31, 2012
Raw materials	\$321	\$1,487
Work-in-process	6	1,595
Finished goods	5,068	11,785
Total inventories	\$5,395	\$14,867

## 8. Other Intangible Assets

Other intangible assets consist of the following:

	As of September 30, 2013 (In thousands)	December 31, 2012
Customer relationships	\$30,100	\$30,100
Tradenname	2,800	2,800
Total intangible assets	32,900	32,900
Less: accumulated amortization	(13,746)	(9,937)
Total	\$19,154	\$22,963

The Company recorded \$32.9 million of other intangible assets in the year ended December 31, 2011 as a result of the acquisition of Neighborhood Diabetes. The Company determined that the estimated useful life of the customer relationships asset is 10 years and is amortizing the asset over that period using an estimated cash flow pattern. The Company determined



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that the useful life of the Neighborhood Diabetes tradename is 15 years and is amortizing the asset over that period on a straight-line basis. Accumulated amortization on the customer relationship asset was \$13.3 million and \$9.6 million as of September 30, 2013 and December 31, 2012, respectively. Accumulated amortization on the tradename asset was \$0.4 million and \$0.3 million as of September 30, 2013 and December 31, 2012, respectively. Amortization expense was approximately \$1.1 million and \$1.4 million for the three months ended September 30, 2013 and 2012, respectively. Amortization expense was approximately \$3.8 million and \$4.6 million for the nine months ended September 30, 2013 and 2012, respectively. Amortization expense for the year ending December 31, 2013 is expected to be approximately \$4.9 million. As of September 30, 2013, the weighted average amortization period of the Company's intangible assets is approximately 8 years.

In April 2013, the Company was notified that Neighborhood Diabetes was not offered a contract under the Center for Medicare & Medicaid Services ("CMS") national mail-order competition of the Medicare Durable Medical Equipment, Prosthetics, Orthotics, and Supplies ("DMEPOS") Competitive Bidding Program. As of July 1, 2013, the program implementation date, the Company is no longer eligible to provide certain mail-order diabetic testing supplies such as blood glucose testing strips and lancets to Medicare beneficiaries. The Company performed an analysis of the future undiscounted cash flows of its customer relationship and tradename assets and determined that the carrying value of the assets is recoverable. No impairment of these intangible assets was recorded in the nine months ended September 30, 2013.

## 9. Goodwill

The Company follows the provisions of FASB ASC Topic 350-20, Intangibles – Goodwill and Other ("ASC 350-20"). ASC 350-20 requires companies to use the purchase method of accounting for all business combinations initiated after June 30, 2001, and establishes specific criteria for the recognition of intangible assets separately from goodwill. Goodwill and indefinite-lived assets are tested for impairment at least annually. In accordance with ASC 350-20, the Company tests goodwill for impairment on an annual basis or whenever events and circumstances indicate there might be an impairment. The Company's goodwill arose in connection with the acquisition of Neighborhood Diabetes in June 2011. No goodwill impairment was recorded in the nine months ended September 30, 2013.

## 10. Product Warranty Costs

The Company provides a four-year warranty on its PDMs and may replace any OmniPods that do not function in accordance with product specifications. Warranty expense is estimated and recorded in the period that shipment occurs. The expense is based on the Company's historical experience and the estimated cost to service the claims. A reconciliation of the changes in the Company's product warranty liability is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(In thousands)			
Balance at the beginning of the period	\$2,401	\$1,822	\$1,992	\$1,960
Warranty expense	1,110	645	2,771	1,867
Warranty claims settled	(702)	(661)	(1,954)	(2,021)
Balance at the end of the period	\$2,809	\$1,806	\$2,809	\$1,806
	As of September 30, 2013		December 31, 2012	
	(In thousands)			
Composition of balance:				
Short-term	\$1,047		\$863	
Long-term	1,762		1,129	

\$2,809

\$1,992



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## 11. Commitments and Contingencies

## Operating Leases

The Company leases its facilities in Massachusetts, New York, Florida, and Singapore. The Company's leases are accounted for as operating leases. The leases generally provide for a base rent plus real estate taxes and certain operating expenses related to the leases. The Company has extended the leases of its facilities in Bedford and Billerica, Massachusetts. Following the extensions, these leases expire in September 2014. The leases for Bedford contain a five-year renewal option and escalating payments over the life of the lease.

During the year ended December 31, 2012, the Company terminated a lease for one of its corporate office spaces in Bedford, Massachusetts. The lease termination resulted in no material impact to the financial statements. During the same period, the Company entered into a new lease agreement for an additional 26,500 square feet in Bedford, Massachusetts. This lease expires in September 2014 and includes escalating payments over its term. During the nine months ended September 30, 2013, the Company extended the lease of its Woburn location. Following the extension, the lease expires in December 2014. The leases in Florida, and New York, and Singapore expire in December 2013, April 2015, and July 2015, respectively.

Certain of the Company's operating lease agreements contain scheduled rent increases, which are being amortized over the terms of the agreements using the straight-line method and are included in other liabilities in the accompanying consolidated balance sheet. The aggregate future minimum lease payments related to these leases as of September 30, 2013, are as follows (in thousands):

Year Ending	Minimum Lease
December 31, 2013 (remaining)	Payments 361
2014	1,134
2015	96
Total	\$ 1,591

## Legal Proceedings

In August 2010, Becton, Dickinson and Company ("BD"), filed a lawsuit in the United States District Court in the State of New Jersey against the Company alleging that the OmniPod System infringes three of its patents. BD seeks a declaration that the Company has infringed its patents, equitable relief, including an injunction that would enjoin the Company from infringing these patents and an unspecified award for monetary damages. The Company believes that the OmniPod System does not infringe these patents. The Company expects that this litigation will not have a material adverse impact on its financial position or results of operations. The Company believes it has meritorious defenses to this lawsuit; however, litigation is inherently uncertain and there can be no assurance as to the ultimate outcome or effect of this action. The Company does not believe it has any material financial exposure with regard to this action at September 30, 2013.

In April 2013, Rydex Technologies LLC ("Rydex"), a non-practicing entity, filed a lawsuit in the United States District Court in the State of Delaware against the Company alleging that certain of its products, including the OmniPod System, infringe one of its patents. Rydex seeks a declaration that the Company has infringed its patent and an unspecified award for monetary damages. The Company believes that the OmniPod System does not infringe this patent. The Company expects that this litigation will not have a material adverse impact on its financial position or results of operations. The Company believes it has meritorious defenses to this lawsuit; however, litigation is inherently uncertain and there can be no assurance as to the ultimate outcome or effect of this action. The Company does not believe it has any material financial exposure with regard to this action at September 30, 2013.

In September 2013, the Company entered into a Settlement and Cross-License Agreement (the "Settlement Agreement") with Medtronic MiniMed Inc., Medtronic Puerto Rico Operations Co. and MiniMed Distribution Corp. (collectively, "Medtronic") of the lawsuit brought by Medtronic in United States District Court for the Central District of California alleging that the Company infringes certain Medtronic patents. The Settlement Agreement was entered into in full settlement of the patent infringement suit brought by Medtronic against the Company, which lawsuit was dismissed

with prejudice on October 2, 2013. The Settlement Agreement provides for a one-time cash payment by the Company to Medtronic and a cross-license of certain patent claims. These licenses may generally not be assigned or sublicensed, but include “have made” licenses solely for each party's own sale of its products. Each license will terminate if the licensee is acquired by an entity in the business of manufacturing, marketing or distributing ambulatory external insulin pumps. In addition, each party agrees not to sue the other for patent infringement based on any existing product, or any feature, element or component, or any

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existing combination thereof, as exist in any currently existing commercially available products. The Company has recorded approximately \$10 million of expense, included in general and administrative expenses on its consolidated statement of operations, related to the one-time cash payment and associated legal fees in connection with the lawsuit.

In October 2013, the Company received a letter from the Office of the Massachusetts Attorney General contending that prior to September 2012 Neighborhood Diabetes engaged in improper sales practices by automatically refilling certain prescriptions for MassHealth patients. The Company is in the process of responding to this letter, and believes that Neighborhood Diabetes' refill practices during the period in question were appropriate and consistent with applicable laws. In light of the preliminary nature of this matter, the Company is unable to reasonably assess its ultimate outcome. However, the Company does not believe that a negative outcome is probable at September 30, 2013, nor could the Company estimate a range of possible loss.

### Indemnifications

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnifications. The Company's exposure under these agreements is unknown because it involves claims that may be made against the Company in the future, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

In accordance with its bylaws, the Company has indemnification obligations to its officers and directors for certain events or occurrences, subject to certain limits, while they are serving at the Company's request in such capacity. There have been no claims to date, and the Company has a director and officer insurance policy that enables it to recover a portion of any amounts paid for future claims.

At September 30, 2013, the Company is subject to an on-going sales and use tax audit by the Massachusetts Department of Revenue related to Neighborhood Diabetes for a period prior to the acquisition. Under the Merger Agreement, the Company has been indemnified by the former Stockholders of Neighborhood Diabetes for any liability resulting from or related to any tax attributable to pre-acquisition periods. The Company has recorded a contingent liability in current liabilities and a corresponding indemnification asset in current assets related to the estimated sales tax payable to the state of Massachusetts for the period under audit.

### 12. Equity

In January 2013, in a public offering, the Company issued and sold 4,715,000 shares of its common stock at a price of \$20.75 per share. In connection with the offering, the Company received total gross proceeds of \$97.8 million, or approximately \$92.8 million in net proceeds after deducting underwriting discounts and offering expenses.

In May 2013, the Company entered into an Exchange Agreement with a holder of its 5.375% Notes. Under the Exchange Agreement, the Company issued 620,122 shares of its common stock to the holder in exchange for the extinguishment of \$13 million in principal amount of the 5.375% Notes. In June 2013, in connection with the repayment of the remaining \$2 million in principal amount of the 5.375% Notes, the Company issued 26,523 shares of its common stock to the holders representing the conversion value in excess of the principal amount as per the conversion terms of the 5.375% Notes.

The Company grants share-based awards to employees in the form of options to purchase the Company's common stock, the ability to purchase stock at a discounted price under the employee stock purchase plan and restricted stock units. Stock-based compensation expense related to share-based awards recognized in the three month periods ended September 30, 2013 and 2012 was \$3.0 million and \$2.3 million, respectively, and was calculated based on awards ultimately expected to vest. Stock-based compensation expense related to share-based awards recognized in the nine month periods ended September 30, 2013 and 2012 was \$9.8 million and \$7.5 million, respectively, and was calculated based on awards ultimately expected to vest. At September 30, 2013, the Company had \$26.6 million of total unrecognized compensation expense related to stock options and restricted stock units.



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## Stock Options

In May 2007, in conjunction with the Company's initial public offering, the Company adopted its 2007 Stock Option and Incentive Plan (the "2007 Plan"). The Company originally reserved 535,000 shares of common stock for issuance under the 2007 Plan in which the amount was increased on each January 1 through January 1, 2012 by 725,000 shares. The 2007 Plan was amended and restated in November 2008 and May 2012 to provide for the issuance of additional shares and to amend certain other provisions. In May 2012, shares available for grant under the 2007 Plan were increased by 3,775,000 shares.

The following summarizes the activity under the Company's stock option plans:

	Number of Options (#)	Weighted Average Exercise Price (\$)	Aggregate Intrinsic Value (\$)	
			(In thousands)	
Balance, December 31, 2012	2,502,190	\$ 13.51		
Granted	276,900	25.54		
Exercised	(595,159 )	10.30	\$ 10,930	( 1 )
Canceled	(53,371 )	19.36		
Balance, September 30, 2013	2,130,560	\$ 15.82	\$ 43,499	
Vested, September 30, 2013	1,302,995	\$ 12.70	\$ 30,676	( 2 )
Vested and expected to vest, September 30, 2013 (3)	1,827,646		\$ 38,633	( 2 )

(1) The aggregate intrinsic value was calculated based on the positive difference between the fair market value of the Company's common stock as of the date of exercise and the exercise price of the underlying options.

(2) The aggregate intrinsic value was calculated based on the positive difference between the fair market value of the Company's common stock as of September 30, 2013 and the exercise price of the underlying options.

Represents the number of vested options as of September 30, 2013, plus the number of unvested options expected (3) to vest as of September 30, 2013, based on the unvested options outstanding as of September 30, 2013, adjusted for the estimated forfeiture rate of 16%.

At September 30, 2013 there were 2,130,560 options outstanding with a weighted average exercise price of \$15.82 per share and a weighted average remaining contractual life of 6.9 years. At September 30, 2013 there were 1,302,995 options exercisable with a weighted average exercise price of \$12.70 per share and a weighted average remaining contractual life of 5.8 years.

Employee stock-based compensation expense related to stock options recognized in the three month periods ended September 30, 2013 and 2012 was \$1.1 million and \$1.2 million, respectively, and was based on awards ultimately expected to vest. Employee stock-based compensation expense related to stock options recognized in the nine month periods ended September 30, 2013 and 2012 was \$3.6 million and \$3.7 million, respectively, and was based on awards ultimately expected to vest. At September 30, 2013, the Company had \$8.1 million of total unrecognized compensation expense related to stock options that will be recognized over a weighted average period of 1.2 years.

## Employee Stock Purchase Plan

As of September 30, 2013 and 2012 the Company had zero shares contingently issued under the employee stock purchase plan ("ESPP"). In the three and nine months ended September 30, 2013 and 2012, the Company recorded no significant stock-based compensation charges related to the ESPP.

## Restricted Stock Units

In the nine months ended September 30, 2013, the Company awarded 563,875 restricted stock units to certain employees and directors. The restricted stock units were granted under the 2007 Plan and vest annually over three to four years from the grant date. Of the 563,875 restricted stock units granted during the period, 142,000 restricted stock units were granted as performance-based awards that are probable of being achieved and vest over a three year period

if certain performance criteria are met. The restricted stock units granted have a weighted average fair value of \$23.93 per share based on the closing price of the Company's common stock on the date of grant. The restricted stock units granted during the nine months ended

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September 30, 2013 were valued at approximately \$13.5 million on their grant date, and the Company is recognizing the compensation expense over the vesting period. Approximately \$1.9 million and \$1.1 million of stock-based compensation expense related to the vesting of restricted stock units was recognized in the three months ended September 30, 2013 and 2012, respectively. Approximately \$6.2 million and \$3.8 million of stock-based compensation expense related to the vesting of restricted stock units was recognized in the nine months ended September 30, 2013 and 2012, respectively. Approximately \$18.5 million of the fair value of the restricted stock units remained unrecognized as of September 30, 2013 and will be recognized over a weighted average period of 1.5 years. Under the terms of the awards, the Company will issue shares of common stock on each of the vesting dates. The following table summarizes the status of the Company's restricted stock units:

	Number of Shares (#)	Weighted Average Fair Value (\$)
Balance, December 31, 2012	825,068	\$18.40
Granted	563,875	23.93
Vested	(301,241	) 17.60
Forfeited	(53,425	) 20.26
Balance, September 30, 2013	1,034,277	\$21.55

## 13. Income Taxes

The Company accounts for income taxes under ASC 740-10. Deferred income tax assets and liabilities are determined based upon differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to be reversed. A valuation allowance is required to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. At September 30, 2013 and December 31, 2012, the Company provided a valuation allowance for the full amount of its net deferred tax asset because realization of any future tax benefit was not sufficiently assured.

Income tax expense (benefit) consists of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Current	\$(20	) \$15	\$171	\$78
Deferred	25	13	83	65
Total	\$5	\$28	\$254	\$143

In the three and nine months ended September 30, 2013 and 2012, the current portion of income tax expense primarily relates to state, local and foreign taxes and the deferred portion primarily relates to federal and state tax amounts.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes as well as federal and state net operating losses and tax credit carryforwards. At September 30, 2013 and December 31, 2012, the Company included \$0.5 million of current deferred tax assets in prepaid expenses and other current assets. At September 30, 2013 and December 31, 2012, the Company included \$0.8 million and \$0.7 million, respectively of non-current deferred tax liabilities in other long-term liabilities on its balance sheet.

In the future, the Company will generate additional deferred tax assets and liabilities related to its amortization of acquired intangible assets for tax purposes because these long-lived intangible assets are not amortized for financial reporting purposes. The tax amortization in future years will give rise to a temporary difference and a tax liability, which will only reverse at the time of ultimate sale or further impairment of the underlying intangible assets. Due to the uncertain timing of this reversal, the temporary difference cannot be considered as a source of future taxable

income for purposes of determining a valuation allowance; therefore, the tax liability cannot be used to offset the deferred tax asset related to the net operating loss carryforward for tax purposes that will be generated by the same amortization.



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The Company had no unrecognized tax benefits at September 30, 2013.

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

You should read the following discussion of our financial condition and results of operations in conjunction with our consolidated financial statements and the accompanying notes to those financial statements included in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q contains forward-looking statements which are made pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933 and of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on our current expectations and beliefs concerning future developments and their potential effects on us. There can be no assurance that future developments affecting us will be those that we have anticipated. These forward-looking statements involve a number of risks, uncertainties (some of which are beyond our control) or other assumptions that may cause actual results or performance to be materially different from those expressed or implied by these forward-looking statements. These risks and uncertainties include, but are not limited to: risks associated with our dependence on the OmniPod System; our ability to reduce production costs and increase customer orders and manufacturing volumes; adverse changes in general economic conditions; impact of healthcare reform legislation; our inability to raise additional funds in the future on acceptable terms or at all; potential supply problems or price fluctuations with sole source or other third-party suppliers on which we are dependent; failure by us to retain supplier pricing discounts and achieve satisfactory gross margins; failure by us to retain key supplier and payor partners; international business risks; our inability to obtain adequate coverage or reimbursement from third-party payors for the OmniPod System and potential adverse changes in reimbursement rates or policies relating to the OmniPod; failure to retain key partner payors and their members; failure to retain and manage successfully our Medicare and Medicaid business; potential adverse effects resulting from competition with competitors; technological innovations adversely affecting our business; potential termination of our license to incorporate a blood glucose meter into the OmniPod System; our ability to protect our intellectual property and other proprietary rights; conflicts with the intellectual property of third parties, including claims that our current or future products infringe the proprietary rights of others; adverse regulatory or legal actions relating to the OmniPod System; failure of our contract manufacturers or component suppliers to comply with FDA's quality system regulations, the potential violation of federal or state laws prohibiting "kickbacks" or protecting patient health information, or any challenges to or investigations into our practices under these laws; product liability lawsuits that may be brought against us; reduced retention rates; unfavorable results of clinical studies relating to the OmniPod System or the products of our competitors; potential future publication of articles or announcement of positions by physician associations or other organizations that are unfavorable to our products; the concentration of substantially all of our manufacturing capacity at a single location in China and substantially all of our inventory at a single location in Massachusetts; our ability to attract and retain key personnel; our ability to manage our growth; fluctuations in quarterly results of operations; risks associated with potential future acquisitions; our ability to generate sufficient cash to service all of our indebtedness; the expansion of our distribution network; our ability to successfully maintain effective internal controls; the volatility of our common stock; risks related to future sales of our common stock or the conversion of the 3.75% Notes; potential limitations on our ability to use our net operating loss carryforwards; anti-takeover provisions in our organizational documents; and other risks and uncertainties described in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on February 28, 2013 in the section entitled "Risk Factors," and in our other filings from time to time with the Securities and Exchange Commission. Should one or more of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, actual results may vary in material respects from those projected in these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements.

Overview

We are primarily engaged in the development, manufacturing and sale of our proprietary OmniPod Insulin Management System (the "OmniPod System"), an innovative, discreet and easy-to-use insulin infusion system for people with insulin-dependent diabetes. The OmniPod System is the only commercially-available insulin infusion system of its kind. The OmniPod System features a unique disposable tubeless OmniPod which is worn on the body for approximately three days at a time and the handheld, wireless Personal Diabetes Manager ("PDM"). Conventional insulin pumps require people with insulin-dependent diabetes to learn to use, manage and wear a number of

cumbersome components, including up to 42 inches of tubing. In contrast, the OmniPod System features two discreet, easy-to-use devices that eliminate the need for a bulky pump, tubing and separate blood glucose meter, provides for virtually pain-free automated cannula insertion, communicates wirelessly and integrates a blood glucose meter. We believe that the OmniPod System's unique proprietary design offers significant lifestyle benefits to people with insulin-dependent diabetes.

In June 2011, we acquired Neighborhood Holdings, Inc. and its wholly-owned subsidiaries (collectively, "Neighborhood Diabetes") in order to support our sales of the OmniPod System, expand our full suite diabetes management product offerings and obtain access to a larger number of insulin dependent patients. Through Neighborhood Diabetes, we are

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able to provide customers with blood glucose testing supplies, traditional insulin pumps, pump supplies and pharmaceuticals and have the ability to process claims as either durable medical equipment or through pharmacy benefits.

We began commercial sale of the OmniPod System in the United States in October 2005. We sell the OmniPod System and other diabetes management supplies in the United States through direct sales to customers or through our distribution partners. The OmniPod System is currently available in multiple countries in Europe through our exclusive distribution partner, Ypsomed Distribution AG (“Ypsomed”) and in Canada through our exclusive distribution partner, GlaxoSmithKline Inc. (“GSK”). In August 2011, we received CE Mark approval, and in December 2012 we received 510(k) clearance by the FDA for our new OmniPod System. The new OmniPod System is more than one-third smaller and one-quarter lighter than the original model, while maintaining the same features and operating capabilities. Ypsomed began selling the new OmniPod System in certain European countries in 2012. We began selling the new OmniPod System to new customers in the U.S. during the first quarter of 2013 and began converting the existing customer base during the second quarter of 2013. By the end of the third quarter, we completely transitioned our production to the the new OmniPod System.

We sell our proprietary OmniPod System as well as blood glucose testing supplies, traditional insulin pumps, pump supplies, pharmaceuticals and other products for the management and treatment of diabetes to people with diabetes. Through our infrastructure in the reimbursement, billing and collection areas, we are able to provide for adjudication of claims as either durable medical equipment or through pharmacy benefits. Claims are adjudicated under private insurers, Medicaid or Medicare. As we expand our sales and marketing focus, increase our manufacturing capacity, expand to additional international markets and broaden our high-touch patient model, we will need to maintain and expand available reimbursement for our product offerings.

Our sales and marketing effort is focused on generating demand and acceptance of the OmniPod System among key diabetes practitioners, academic medical centers, clinics, people with insulin-dependent diabetes, third-party payors, government agencies, and third-party distributors. Our marketing strategy is to build awareness for the benefits of the OmniPod System as well as our high-touch patient model through a wide range of education programs, social networking, patient demonstration programs, support materials, media advertisements and events at the national, regional and local levels. We are using third-party distributors to improve our access to managed care and government reimbursement programs, expand our commercial presence and provide access to additional potential patients. Our total revenue was \$61.1 million and \$178.6 million for the three and nine months ended September 30, 2013, respectively. Our total revenue was \$54.8 million and \$153.5 million for the three and nine months ended September 30, 2012, respectively.

We currently produce the OmniPod System on partially automated manufacturing lines at a facility in China operated by a subsidiary of Flextronics International Ltd. (“Flextronics”). We purchase complete OmniPods pursuant to our agreement with Flextronics. Under the agreement, Flextronics has agreed to supply us, as a non-exclusive supplier, with OmniPods at agreed upon prices per unit pursuant to a rolling forecast that we provide. The current term of the agreement expires in December 2017 and is automatically renewed for one-year terms subsequently. It may be terminated upon prior written notice given no less than a specified number of days prior to the date of termination. The specified number of days is intended to provide the parties with sufficient time to make alternative arrangements in the event of termination.

To achieve profitability, we continue to seek to increase manufacturing volume and reduce the per-unit production cost for the OmniPod. By increasing production volumes of the OmniPod, we have been able to reduce our per-unit raw material costs and improve absorption of manufacturing overhead costs. Our new OmniPod was designed to further lower the cost of the product through component sourcing, volume discounts and efficient manufacturing. The cost reductions are important as we strive to achieve profitability. We believe our current manufacturing capacity is sufficient to meet our expected 2013 demand for OmniPods.

We purchase certain other diabetes management supplies from manufacturers at contracted rates and supply these products to our customers. Based on market penetration, payor plans and other factors, certain manufacturers provide rebates based on product sold. We record these rebates as a reduction to cost of goods sold as they are earned.

Since our inception in 2000, we have incurred losses every quarter. In the three and nine months ended September 30, 2013, we incurred net losses of \$21.3 million and \$42.5 million, respectively. As of September 30, 2013, we had an accumulated deficit of \$524.0 million. We have financed our operations through private placements of debt and equity securities, public offerings of our common stock, issuances of convertible debt and borrowings under certain other debt agreements. As of September 30, 2013, we had \$143.8 million of convertible debt outstanding which matures in June 2016.

Our long-term financial objective is to achieve and sustain profitable growth. Our efforts in the remainder of 2013 will be focused primarily on the production of, and customer transition to, our new OmniPod System as well as the expansion of our customer base in the United States and internationally. Achieving these objectives is expected to require additional investments in certain personnel and initiatives. We believe that we will continue to incur net losses in the near term in order to achieve

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these objectives. However, we believe that the accomplishment of our near term objectives will have a positive impact on our financial condition in the future.

In January 2013, we sold 4.7 million shares of our common stock at a price of \$20.75 per share, resulting in net proceeds to us of \$92.8 million. We believe that our cash and cash equivalents, together with the cash expected to be generated from product sales, will be sufficient to meet our projected operating and debt service requirements for the next twelve months.

### Financial Operations Overview

**Revenue.** We derived most of our revenue from the sale of the OmniPod System and other diabetes related products including blood glucose testing supplies, traditional insulin pumps, pump supplies and pharmaceuticals to customers and third-party distributors who resell the product to customers. The OmniPod System is comprised of two devices: the OmniPod, a disposable insulin infusion device that the patient wears for up to three days and then replaces; and the PDM, a handheld device much like a personal digital assistant that wirelessly programs the OmniPod with insulin delivery instructions, assists the patient with diabetes management and incorporates a blood glucose meter.

In June 2011, we entered into a development agreement with a U.S. based pharmaceutical company (the "Development Agreement"). Under the Development Agreement, we are required to perform design, development, regulatory, and other services to support the pharmaceutical company as it works to obtain regulatory approval to use our drug delivery technology as a delivery method for its pharmaceutical. Over the term of the Development Agreement, we have and expect to continue to invoice amounts as we meet certain defined deliverable milestones. Revenue on the Development Agreement is recognized using a proportional performance methodology based on costs incurred and total payments under the agreement. The impact of changes in the expected total effort or contract payments are recognized as a change in estimate using the cumulative catch-up method.

As of September 30, 2013 and December 31, 2012, we had deferred revenue of \$0.6 million and \$5.4 million, respectively. These amounts include product-related revenue and unrecognized amounts related to the Development Agreement.

For the year ending December 31, 2013 we expect our revenue to continue to increase as we transition our customers to our new OmniPod System, leverage our high-touch patient model to gain new customers in the United States and continue expansion in Europe, Canada and certain other international markets. Increased revenue will be dependent upon the success of our sales efforts, our ability to produce our new OmniPods in sufficient volumes as our patient base grows, the successful transition to our new OmniPod System, the impact of competitive bidding on certain durable medical equipment items including mail-order diabetes testings supplies, and other risks and uncertainties.

**Cost of revenue.** Cost of revenue consists primarily of raw material, labor, warranty and overhead costs such as freight, depreciation and other costs related to the OmniPod System, the cost of products we acquire from third party suppliers, and costs incurred related to the Development Agreement. Cost of revenue will continue to increase in line with an increase in revenue.

**Research and development.** Research and development expenses consist primarily of personnel costs within our product development, regulatory and clinical functions, and the costs of clinical studies and product development projects. We expense all research and development costs as incurred. For the remainder of the year ending December 31, 2013, we expect overall research and development spending to remain consistent with current levels.

**General and administrative.** General and administrative expenses consist primarily of salaries and other related costs for personnel serving the executive, finance, information technology and human resource functions, as well as legal fees, accounting fees, insurance costs, bad debt expenses, shipping, handling and facilities-related costs. For the remainder of the year ending December 31, 2013, we expect general and administrative expenses to decrease as compared to current levels as we incurred significant one-time costs related to the transition to the new OmniPod System and the resolution of our outstanding litigation with Medtronic Minimed Inc.

**Sales and marketing.** Sales and marketing expenses consist primarily of personnel costs within our sales, marketing, reimbursement support, customer support and training functions, sales commissions paid to our sales representatives and costs associated with participation in medical conferences, physician symposia and promotional activities, including distribution of units used in our demonstration kit programs. For the remainder of the year ending December

31, 2013, we expect sales and marketing expenses to decrease slightly compared to current levels as certain costs associated with the launch of the new OmniPod are not expected to recur.

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## Results of Operations

The following table presents certain statement of operations information for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,			Nine Months Ended September 30,			
	2013	2012	% Change	2013	2012	% Change	
	(In thousands)			(In thousands)			
Revenue	\$61,103	\$54,752	12	% \$178,551	\$153,541	16	%
Cost of revenue	33,708	30,362	11	% 99,168	86,524	15	%
Gross profit	27,395	24,390	12	% 79,383	67,017	18	%
Operating expenses:							
Research and development	5,771	6,559	12	% 15,341	18,512	17	%
General and administrative	23,530	12,731	85	% 50,525	38,416	32	%
Sales and marketing	15,407	13,571	14	% 42,858	39,974	7	%
Total operating expenses	44,708	32,861	36	% 108,724	96,902	12	%
Operating loss	(17,313 )	(8,471 )	104	% (29,341 )	(29,885 )	2	%
Other expense, net	(3,972 )	(3,918 )	1	% (12,879 )	(11,645 )	11	%
Income tax expense	(5 )	(28 )	82	% (254 )	(143 )	78	%
Net loss	\$(21,290 )	\$(12,417 )	71	% \$(42,474 )	\$(41,673 )	2	%

Comparison of the Three and Nine Months ended September 30, 2013 and 2012

## Revenue

Our total revenue was \$61.1 million and \$178.6 million for the three and nine months ended September 30, 2013, respectively, compared to \$54.8 million and \$153.5 million for the same periods in 2012. The increase in the three and nine month periods is due to continued adoption of the OmniPod System by patients in the United States and internationally. This increase was offset by a decrease in revenue related to certain mail-order diabetic testing supplies such as blood glucose testing strips and lancets to Medicare beneficiaries that we no longer are eligible to service under the Medicare Durable Medical Equipment, Prosthetics, Orthotics, and Supplies ("DMEPOS") Competitive Bidding Program, which began on July 1, 2013.

## Cost of Revenue

Cost of revenue was \$33.7 million and \$99.2 million for the three and nine months ended September 30, 2013, respectively, compared to \$30.4 million and \$86.5 million for the same periods in 2012. The increase in cost of revenue reflects the higher sales volumes as our patient base continues to increase.

## Research and Development

Research and development expenses decreased \$0.8 million, or 12%, to \$5.8 million for the three months ended September 30, 2013, compared to \$6.6 million for the same period in 2012. The decrease was primarily a result of a decrease of \$0.9 million in outside services associated with the development and regulatory approval of the new OmniPod System and a \$0.8 million decrease in supplies and consumables used in development efforts on our ongoing projects. These decreases were offset by a \$0.8 million increase in employee related and travel expenses. Research and development expenses decreased \$3.2 million, or 17%, to \$15.3 million for the nine months ended September 30, 2013, compared to \$18.5 million for the same period in 2012. The decrease was primarily a result of a decrease of \$3.5 million in outside services associated with the development and regulatory approval of the new OmniPod System and a \$0.9 million decrease in supplies and consumables used in development efforts on our ongoing projects, offset by a \$1.2 million increase in employee related expenses.



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## General and Administrative

General and administrative expenses increased \$10.8 million, or 85%, to \$23.5 million for the three months ended September 30, 2013 compared to \$12.7 million for the same period in 2012. This increase was primarily the result of an increase of \$7.3 million in legal expenses largely related to the Medtronic patent litigation settlement, an expense of \$2.5 million related to equipment which is no longer expected to be used in our manufacturing process, an increase of \$0.8 million of shipping expenses as volumes of patient shipments increased, an increase of \$0.5 million in bad debt expense, and an increase of \$0.5 million in employee related expenses including stock-based compensation. These increases were partially offset by a decrease of \$0.7 million related to sales and use tax compliance and a decrease of \$0.3 million in amortization expense related to the customer relationship asset acquired in the June 2011 acquisition of Neighborhood Diabetes.

General and administrative expenses increased \$12.1 million, or 32%, to \$50.5 million for the nine months ended September 30, 2013 compared to \$38.4 million for the same period in 2012. This increase was primarily the result of an increase of \$8.3 million in legal expense mainly related to the Medtronic patent litigation settlement, an expense of \$2.5 million related to equipment which is no longer expected to be used in our manufacturing process, an increase of \$1.6 million in bad debt expense, an increase of \$1.3 million in employee related expenses including stock-based compensation, and an increase of \$0.9 million of shipping expenses as volumes of patient shipments increased. These increases were partially offset by a decrease of \$1.1 million in administrative and consulting fees, a decrease of \$0.8 million in amortization expense related to the customer relationship asset acquired in the June 2011 acquisition of Neighborhood Diabetes, and a decrease of \$0.6 million related to sales and use tax compliance.

## Sales and Marketing

Sales and marketing expenses increased \$1.8 million, or 14%, to \$15.4 million for the three months ended September 30, 2013, compared to \$13.6 million for the same period in 2012. This increase was primarily a result of a \$1.4 million increase in costs associated with the launch of the new OmniPod System, and an increase of \$1.0 million in costs related to customer support functions and strategic planning initiatives. These increases were offset by a decrease of \$0.6 million of employee related expenses including stock-based compensation and travel related expenses.

Sales and marketing expenses increased \$2.9 million, or 7%, to \$42.9 million for the nine months ended September 30, 2013, compared to \$40.0 million for the same period in 2012. This increase was primarily a result of a \$0.9 million net increase in costs associated with the launch of the new OmniPod System and other advertising expenses and a \$2.0 million increase in costs related to customer support functions and strategic planning initiatives.

## Other Expense, Net

Other expense, net mainly consists of interest income and interest and other expense. Net interest and other expense was \$4.0 million for the three months ended September 30, 2013 compared to \$3.9 million for the same period in 2012. Net interest and other expense was \$12.9 million for the nine months ended September 30, 2013 compared to \$11.6 million for the same period in 2012. The increase in net interest and other expense is primarily the result of higher non-cash interest on the 5.375% Notes and the 3.75% Notes based on their effective interest rates and the \$0.3 million charge recorded for the extinguishment of debt related to the exchange of 620,122 shares of common stock for \$13 million in principal amount of the 5.375% Notes (as defined below).

## Income Tax Expense

Income tax expense was de minimus for each of the three months ended September 30, 2013 and 2012. Income tax expense was \$0.3 million and \$0.1 million for the nine months ended September 30, 2013 and 2012, respectively. Income tax expense is comprised of a current and deferred portion. The current portion primarily related to state, local and foreign taxes and the deferred portion primarily related to federal and state tax amounts.

## Liquidity and Capital Resources

We commenced operations in 2000 and to date we have financed our operations primarily through private placements of common and preferred stock, secured indebtedness, public offerings of our common stock and issuances of convertible debt. As of September 30, 2013, we had \$153.9 million in cash and cash equivalents. We believe that our current cash and cash equivalents, together with the cash expected to be generated from sales, will be sufficient to

meet our projected operating and debt service requirements for at least the next twelve months.

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## Equity

In January 2013, in a public offering, we issued and sold 4,715,000 shares of our common stock at a price of \$20.75 share. In connection with the offering, we received total gross proceeds of \$97.8 million, or approximately \$92.8 million in net proceeds after deducting underwriting discounts and offering expenses.

In May 2013, we entered into an Exchange Agreement with a holder of our 5.375% Notes. Under the Exchange Agreement, we issued 620,122 shares of our common stock to the holder in exchange for the extinguishment of \$13 million in principal amount of the 5.375% Notes. In June 2013, in connection with the repayment of the remaining \$2 million in principal amount of the 5.375% Notes, we issued 26,523 shares of our common stock to the holders representing the conversion value in excess of the principal amount as per the conversion terms of the 5.375% Notes.

## Debt

We had outstanding debt and related financing costs on our consolidated balance sheet as follows (in thousands):

	As of September 30, 2013	December 31, 2012
Principal amount of the 5.375% Convertible Senior Notes	\$—	\$15,000
Principal amount of the 3.75% Convertible Senior Notes	143,750	143,750
Unamortized discount	(32,633	) (40,591
Total debt	111,117	118,159
Current portion of long-term debt	—	14,429
Long-term debt	\$111,117	\$103,730
Deferred financing costs	\$1,560	\$2,004

Interest and other expense related to the 5.375% Senior Notes (as defined below) and the 3.75% Senior Notes (as defined below) was included in interest and other expense on the consolidated statements of operations as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Contractual coupon interest	\$1,347	\$1,549	\$4,356	\$4,647
Accretion of debt discount	2,447	2,420	7,958	7,111
Loss on debt extinguishment	—	—	325	—
Amortization of debt issuance costs	146	148	443	445
Total interest and other expense	\$3,940	\$4,117	\$13,082	\$12,203

## 5.375% Convertible Senior Notes

In June 2008, we sold \$85.0 million in principal amount of 5.375% Convertible Senior Notes due June 15, 2013 (the "5.375% Notes") in a private placement to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended. The interest rate on the notes was 5.375% per annum on the principal amount from June 16, 2008, payable semi-annually in arrears in cash on December 15 and June 15 of each year. The 5.375% Notes were convertible into our common stock at an initial conversion rate of 46.8467 shares of common stock per \$1,000 principal amount of the 5.375% Notes, which is equivalent to a conversion price of approximately \$21.35 per share, representing a conversion premium of 34% to the last reported sale price of our common stock on the NASDAQ Global Market on June 10, 2008, subject to adjustment under certain circumstances, at any time beginning on March 15, 2013 or under certain other circumstances and prior to the close of business on the business day immediately preceding the final maturity date of the notes. The 5.375% Notes were convertible for cash up to their principal amount and shares of our common stock for the remainder of the conversion value in excess of the principal amount.

We recorded a debt discount of \$26.9 million to equity to reflect the value of our nonconvertible debt borrowing rate of 14.5% per annum. This debt discount was amortized as non-cash interest expense over the five year term of the 5.375% Notes. We incurred deferred financing costs related to this offering of approximately \$3.5 million, of which \$1.1 million has

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been reclassified as an offset to the value of the amount allocated to equity. The remainder was recorded as other assets in the consolidated balance sheet and was amortized as non-cash interest expense over the five year term of the 5.375% Notes.

In June 2011, in connection with the issuance of \$143.8 million in principal amount of 3.75% Convertible Notes due June 2016 (the "3.75% Notes"), we repurchased \$70 million in principal amount of the 5.375% Notes for \$85.1 million, a 21.5% premium on the principal amount. The investors that held the \$70 million in principal amount of repurchased 5.375% Notes purchased \$59.5 million in principal amount of the 3.75% Notes and retained approximately \$13.5 million in principal amount of the remaining 5.375% Notes. These investors' combined \$73.0 million in principal amount of convertible debt (\$13.5 million of 5.375% Notes and \$59.5 million of 3.75% Notes) was considered to be a modification of a portion of the 5.375% Notes. See the section entitled "3.75% Convertible Senior Notes" below.

In May 2013, we entered into an Exchange Agreement with a holder of our 5.375% Notes. Under the Exchange Agreement, we purchased \$13 million in principal amount of the 5.375% Notes in exchange for 620,122 shares of our common stock and a cash payment of \$0.3 million, representing accrued and unpaid interest. Furthermore, we recorded a loss on extinguishment of debt of \$0.3 million which was included in interest and other expense in the nine months ended September 30, 2013.

In June 2013, we repaid the remaining outstanding principal and accrued interest on the 5.375% Notes in accordance with their terms. In addition to a cash payment of \$2.1 million, representing principal and accrued and unpaid interest, we issued 26,523 shares of our common stock to the holders representing the conversion value in excess of the principal amount as per the terms of the 5.375% Notes.

No cash interest expense was recorded related to the 5.375% Notes in the three month period ended September 30, 2013. Cash interest expense related to the 5.375% Notes was \$0.2 million in the three month period ended September 30, 2012. Cash interest expense related to the 5.375% Notes was \$0.3 million and \$0.6 million in the nine month periods ended September 30, 2013 and 2012, respectively.

#### 3.75% Convertible Senior Notes

In June 2011, we sold \$143.8 million in principal amount of the 3.75% Notes. The interest rate on the notes is 3.75% per annum, payable semi-annually in arrears in cash on December 15 and June 15 of each year. The 3.75% Notes are convertible into our common stock at an initial conversion rate of 38.1749 shares of common stock per \$1,000 principal amount of the 3.75% Notes, which is equivalent to a conversion price of approximately \$26.20 per share, subject to adjustment under certain circumstances. The 3.75% Notes are convertible prior to March 15, 2016 only upon the occurrence of certain circumstances. On and after March 15, 2016 and prior to the close of business on the second scheduled trading day immediately preceding the final maturity date of the 3.75% Notes, the notes may be converted without regard to the occurrence of any such circumstances. The 3.75% Notes and any unpaid interest will be convertible at our option for cash, shares of our common stock or a combination of cash and shares of our common stock for the principal amount. We intend to settle the principal in cash.

We may not redeem the 3.75% Notes prior to June 20, 2014. From June 20, 2014 to June 20, 2015, we may redeem the 3.75% Notes, at our option, in whole or in part, only if the last reported sale price per share of our common stock has been at least 130% of the conversion price then in effect for at least 20 trading days during a period of 30 consecutive trading days. On and after June 20, 2015, we may redeem the 3.75% Notes, at our option (without regard to such sale price condition), in whole or in part. If a fundamental change, as defined in the Indenture for the 3.75% Notes, occurs at any time prior to maturity, holders of the 3.75% Notes may require us to repurchase their notes in whole or in part for cash equal to 100% of the principal amount of the notes to be repurchased, plus accrued and unpaid interest. If a holder elects to convert their 3.75% Notes upon the occurrence of a make-whole fundamental change, as defined in the Indenture for the 3.75% Notes, the holder may be entitled to receive an additional number of shares of common stock on the conversion date. These additional shares are intended to compensate the holders for the loss of the time value of the conversion option and are set forth in the Indenture to the 3.75% Notes. In no event will the number of shares issuable upon conversion of a 3.75% Note exceed 50.5816 per \$1,000 principal amount (subject to adjustment as described in the Indenture for the 3.75% Notes). The 3.75% Notes are unsecured.

We identified certain features related to a portion of the 3.75% Notes, including the holders' ability to require us to repurchase their notes and the higher interest payments required in an event of default, which are considered embedded derivatives and should be bifurcated and accounted for at fair value. We assess the value of each of these embedded derivatives at each balance sheet date. At September 30, 2013, we determined that these derivatives had de minimus value.

In connection with the issuance of the 3.75% Notes, we repurchased \$70 million in principal amount of the 5.375% Notes for \$85.1 million, a 21.5% premium on the principal amount. The investors that held the \$70 million in principal amount of repurchased 5.375% Notes purchased \$59.5 million in principal amount of the 3.75% Notes and retained approximately

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\$13.5 million in principal amount of the remaining 5.375% Notes. This transaction was treated as a modification of the existing 5.375% Notes. We accounted for this modification of a portion of the 5.375% Notes separately from the issuance of the remainder of the 3.75% Notes.

Prior to the transaction, the \$70 million in principal amount of repurchased 5.375% Notes had a debt discount of \$10.5 million. This amount remained in debt discount related to the \$73 million in principal amount of modified debt. We recorded an additional debt discount of \$15.1 million related to the premium payment in connection with the repurchase and \$0.2 million related to the increase in the value of the conversion feature. The portion of the debt discount related to the value of the conversion feature was recorded as additional paid-in capital. The total debt discount of \$25.8 million related to the modified debt is being amortized as non-cash interest expense at the effective rate of 16.5% over the five year term of the modified debt. We paid transaction fees of approximately \$2.0 million related to the modification which were recorded as interest expense at the time of the modification.

Of the \$143.8 million in principal amount of 3.75% Notes issued in June 2011, \$84.3 million in principal amount was considered to be an issuance of new debt. We recorded a debt discount of \$26.6 million related to the \$84.3 million in principal amount of 3.75% Notes. The debt discount was recorded as additional paid-in capital to reflect the value of our nonconvertible debt borrowing rate of 12.4% per annum. This debt discount is being amortized as non-cash interest expense over the five year term of the 3.75% Notes. We incurred deferred financing costs related to this offering of approximately \$2.8 million, of which \$0.9 million has been reclassified as an offset to the value of the amount allocated to equity. The remainder is recorded as other assets in the consolidated balance sheet and is being amortized as non-cash interest expense over the five year term of the 3.75% Notes.

Cash interest expense related to the \$143.8 million in principal amount of 3.75% Notes was \$1.3 million in each of the three month periods ended September 30, 2013 and 2012. Cash interest expense related to the \$143.8 million in principal amount of 3.75% Notes was \$4.0 million in each of the nine month periods ended September 30, 2013 and 2012.

As of September 30, 2013, we included \$111.1 million on our balance sheet in long-term debt related to the 3.75% Notes. The 3.75% Notes have a remaining term of 2.75 years.

Capital Leases

In the nine months ended September 30, 2013, we acquired \$9.0 million of manufacturing equipment under capital leases. The \$9.0 million obligation under the capital leases will be repaid in equal monthly installments over the 36 month terms of the leases and includes principal and interest payments with an effective interest rate of 17%. In the third quarter of 2013, the Company recorded a \$2.5 million charge to expense the value of equipment as it was no longer expected to be used in our manufacturing process. The underlying assets have been recorded at their fair value of \$6.5 million and are included in property and equipment on our balance sheet as of September 30, 2013. The assets acquired under capital leases are being amortized on a straight-line basis over 5 years in accordance with our policy for depreciation of manufacturing equipment. Amortization expense on assets acquired under capital leases is included with depreciation expense.

The aggregate future minimum lease payments related to these capital leases as of September 30, 2013, are as follows (in thousands):

Year Ending December 31,	Minimum Lease Payments
2013 (remaining)	954
2014	3,815
2015	3,815
2016	2,409
Total	\$ 10,993