Inogen Inc
Form S-1/A
February 04, 2014
Table of Contents

Registration No. 333-192605

As filed with the Securities and Exchange Commission on February 4, 2014.

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 4

TO

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

INOGEN, INC.

(Exact name of registrant as specified in its charter)

Delaware	**5960**	**33-0989359**
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification Number)

326 Bollay Drive

Goleta, California 93117

(805) 562-0500

(Address, including ZIP code, and telephone number, including area code, of registrant s principal executive offices)

Raymond Huggenberger

326 Bollay Drive

Goleta, California 93117

(805) 562-0500

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Martin J. Waters	
Robert F. Kornegay	**Charles K. Ruck**
Wilson Sonsini Goodrich & Rosati,	**B. Shayne Kennedy**
Professional Corporation	**Latham & Watkins LLP**
633 West Fifth Street, 15th Floor	**650 Town Center Drive, 20th Floor**
Los Angeles, CA 90071	**Costa Mesa, CA 92626-1925**
Telephone: (323) 210-2900	**Telephone: (714) 540-1235**
Facsimile: (866) 974-7329	**Facsimile: (714) 755-8290**

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, as amended, check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

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

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

CALCULATION OF REGISTRATION FEE CHART

Title of Each Class of Securities to be Registered	Amount to be Registered(1)	Proposed Maximum Offering Price Per Share	Proposed Maximum Aggregate Offering Price(2)	Amount of Registration Fee(3)
Common Stock, par value $0.001 par share	5,073,527	$18.00	$91,323,486	$11,763

(1) Estimated pursuant to Rule 457(a) under the Securities Act of 1933, as amended. Includes an additional 661,764 shares that the underwriters have the option to purchase.
(2) Estimated solely for the purpose of calculating the registration fee.
(3) The Registrant previously paid $11,109 of the registration fee in connection with prior filings of this Registration Statement.

The registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment that specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to such Section 8(a), may determine.

Table of Contents

The information in this prospectus is not complete and may be changed. We and the selling stockholders may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to completion, dated February 4, 2014

Prospectus

4,411,763 shares

Common stock

This is an initial public offering of common stock of Inogen, Inc. We are selling 3,529,411 shares of common stock, and the selling stockholders are selling 882,352 shares of common stock. We will not receive any proceeds from the sale of shares by the selling stockholders. The estimated initial public offering price is expected to be between $16.00 and $18.00 per share.

Prior to this offering, there has been no public market for our common stock. We intend to apply to list our common stock on the NASDAQ Global Market under the symbol INGN.

We are an emerging growth company under applicable Securities and Exchange Commission rules and will be subject to reduced public company reporting requirements.

	Per share	Total
Initial public offering price	$	$
Underwriting discounts and commissions(1)	$	$
Proceeds to Inogen, Inc., before expenses	$	$
Proceeds to selling stockholders	$	$

(1) See Underwriting for additional disclosure regarding underwriting discounts, commissions and estimated offering expenses.
The selling stockholders have granted the underwriters a 30-day option to purchase up to an additional 661,764 shares of common stock.

Investing in our common stock involves a high degree of risk. See Risk factors beginning on page 14.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares to purchasers on or about , 2014.

J.P. Morgan

Leerink Partners

William Blair **Stifel**

, 2014

Table of Contents

Table of Contents

Table of contents

	Page
Prospectus summary	1
Risk factors	14
Special note regarding forward-looking statements	47
Use of proceeds	48
Dividend policy	49
Capitalization	50
Dilution	52
Selected financial data	55
Management s discussion and analysis of financial condition and results of operations	59
Business	99
Management	125
Executive compensation	137
Certain relationships and related party transactions	152
Principal and selling stockholders	155
Description of capital stock	159
Shares eligible for future sale	166
Material U.S. federal income tax consequences to non-U.S. holders of common stock	169
Underwriting	173
Legal matters	181
Experts	181
Change in independent registered public accounting firm	181
Where you can find additional information	182
Index to financial statements, as of and for the years ended December 31, 2012 and 2011	F-1
Index to financial statements, as of and for the nine months ended September 30, 2013 and 2012	F-42

Neither we, the selling stockholders nor the underwriters have authorized anyone to provide any information other than that contained in this prospectus or in any free writing prospectus prepared by or on behalf of us or to which we have referred you. We take no responsibility for, and can provide no assurance as to the reliability of, any other information that others may give you. We, the selling stockholders and the underwriters are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus, regardless of the time of delivery of this prospectus or any sale of our common stock. Our business, financial condition, results of operations and prospects may have changed since that date.

Until , 2014 (25 days after the commencement of this offering), all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to

Table of Contents

deliver a prospectus. This is in addition to the dealers obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

For investors outside of the United States: Neither we, the selling stockholders nor the underwriters have done anything that would permit this offering or possession or distribution of this prospectus in any jurisdiction where action for that purpose is required, other than the United States. Persons outside of the United States who come into possession of this prospectus must inform themselves about, and observe any restrictions relating to, the offering of the shares of common stock and the distribution of this prospectus outside of the United States.

Table of Contents

Prospectus summary

The items in the following summary are described in more detail later in this prospectus. This summary provides an overview of selected information and does not contain all of the information you should consider before buying our common stock. Therefore, you should read the entire prospectus carefully, especially the Risk factors section beginning on page 12 and our financial statements and the related notes appearing at the end of this prospectus, before deciding to invest in our common stock. In this prospectus, unless the context otherwise requires, references to we, us, our or Inogen refer to Inogen, Inc.

Overview

We are a medical technology company that develops, manufactures and markets innovative portable oxygen concentrators used to deliver supplemental long-term oxygen therapy to patients suffering from chronic respiratory conditions. Traditionally, these patients have relied on stationary oxygen concentrator systems for use in the home and oxygen tanks or cylinders for mobile use, which we call the delivery model. The delivery model limits lifestyle flexibility by requiring patients to plan their activities around a finite oxygen supply outside the home and to be tethered to a stationary concentrator in the home. Our proprietary Inogen One systems concentrate the air around the patient to offer a single source of supplemental oxygen anytime, anywhere with a portable device weighing approximately 4.8 or 7.0 pounds. Our systems reduce the patient s reliance on stationary concentrators and scheduled deliveries of tanks with a finite supply of oxygen, thereby improving patient quality of life and fostering mobility.

Although portable oxygen concentrators represent the fastest-growing segment of the Medicare oxygen therapy market, we estimate based on Medicare data from 2012 that patients using portable oxygen concentrators represent approximately 4% to 5% of the total addressable oxygen market in the United States. Based on 2012 industry data, we were the leading worldwide manufacturer of portable oxygen concentrators, as well as the largest provider of portable oxygen concentrators to Medicare patients, as measured by dollar volume. We believe we are the only manufacturer of portable oxygen concentrators that employs a direct-to-consumer strategy in the United States, meaning we market our products to patients, process their physician paperwork, provide clinical support as needed and bill Medicare or private payors on their behalf.

We believe our direct-to-consumer strategy has been critical to driving patient adoption of our technology. Other portable oxygen concentrator manufacturers access patients by selling through home medical equipment providers, which we believe are disincentivized to encourage adoption of portable oxygen concentrators due to their investments in the physical infrastructure and personnel required for the delivery model. Because portable oxygen concentrators eliminate the need for a physical distribution infrastructure, but have higher initial equipment costs than the delivery model, we believe converting to a portable oxygen concentrator model would require significant restructuring and capital investment for home medical equipment providers. Our direct-to-consumer marketing strategy allows us to sidestep the home medical equipment channel, appeal to patients directly and capture both the manufacturing and provider margin associated with long-term oxygen therapy. We believe our ability to capture this top-to-bottom margin, combined with our technology that eliminates most of the delivery model s infrastructure and service requirements, gives us a cost structure advantage over our competitors.

Table of Contents

Since adopting our direct-to-consumer strategy in 2009, we have directly sold or rented our Inogen One systems to more than 40,000 patients, growing our revenue from $10.7 million in 2009 to $48.6 million in 2012. In 2012, approximately 60% of our total revenue came from our direct-to-consumer business and approximately 40% came from our business-to-business sales. Of our direct-to-consumer revenue of $29.0 million in 2012, $19.9 million came from our domestic rental business and $9.1 million came from domestic sales of our systems. Of our business-to-business revenue of $19.6 million in 2012, $13.0 million came from international markets, and $6.7 million came from domestic distributors. We have increased our proportion of both recurring revenue and international revenue in 2012 compared to 2011. In 2012, 26.8% of our revenue came from international markets (versus 25.9% in 2011) and 40.9% from oxygen rentals (versus 35.8% in 2011). Additionally, we have increased our gross margin from 48.0% in 2011 to 49.3% in 2012 by increasing rental mix, improving system reliability, reducing material cost per system and lowering overhead cost per system. Our net loss was $2.6 million in 2009 transitioning to net income of $0.6 million in 2012.

Our market

Overview of oxygen therapy market

We believe the current total addressable oxygen therapy market in the United States is approximately $3 billion to $4 billion, based on 2012 Medicare data and our estimate of the ratio of the Medicare market to the total market. We estimate that more than 2.5 million patients in the United States and more than 4.5 million patients worldwide use oxygen therapy, and more than 60% of oxygen therapy patients in the United States are covered by Medicare. The number of oxygen therapy patients in the United States is projected to grow by approximately 7% to 10% per year between 2013 and 2019, which we believe is the result of earlier diagnosis of chronic respiratory conditions, demographic trends and longer durations of long-term oxygen therapy.

Long-term oxygen therapy has been shown to be a cost-efficient and clinically effective means to treat hypoxemia, a condition in which patients have insufficient oxygen in the blood. Hypoxemic patients are unable to convert oxygen found in the air into the bloodstream in an efficient manner, causing organ damage and poor health. Chronic obstructive pulmonary disease, or COPD, is a leading cause of hypoxemia. Approximately 70% of our patient population has been diagnosed with COPD, which we believe is reflective of the long-term oxygen therapy market in general. Industry sources estimate that 24 million people in the United States suffer from COPD, of which one-half are undiagnosed.

According to our analysis of 2011 and 2012 Medicare data, approximately two-thirds of U.S. oxygen users require ambulatory oxygen and the remaining one-third require only stationary or nocturnal oxygen. Clinical data has shown that ambulatory patients that use oxygen twenty-four hours a day, seven days a week, or 24/7, regardless of whether such patients rely on portable oxygen concentrators or the delivery model, have approximately two times the survival rate and spend at least 60% fewer days annually in the hospital than non-ambulatory 24/7 patients. Of the ambulatory patients, we estimate that approximately 85% rely upon the delivery model that has the following disadvantages:

- limited flexibility outside the home, dictated by the finite oxygen supply provided by tanks and cylinders and dependence on delivery schedules;

Table of Contents

- restricted mobility and inconvenience within the home, as patients must attach long, cumbersome tubing to a noisy stationary concentrator to move within their homes;

- products are not cleared for use on commercial aircraft and cannot plug into a vehicle outlet for extended use; and

- high costs driven by the infrastructure necessary to establish a geographically diverse distribution network to serve patients locally, as well as personnel, fuel and other costs, which have limited economies of scale and generally increase over time.

Portable oxygen concentrators were developed in response to many of the limitations associated with traditional oxygen therapy. Portable oxygen concentrators are designed to offer a self-replenishing, unlimited supply of oxygen that is concentrated from the surrounding air and to operate without the need for oxygen tanks or regular oxygen deliveries, allowing patients to enhance their independence and mobility. Additionally, because portable oxygen concentrators do not require the physical infrastructure and service intensity of the delivery model, we believe portable oxygen concentrators can provide long-term oxygen therapy with a lower cost structure. Despite the ability of portable oxygen concentrators to address many of the shortcomings of traditional oxygen therapy, we estimate based on 2012 Medicare data that the amount spent by patients with portable oxygen concentrators represents approximately 5% to 6% of total oxygen therapy spend. We believe the following has hindered the market acceptance of portable oxygen concentrators:

- to obtain portable oxygen concentrators, patients are dependent on home medical equipment providers, which have made significant investments in the physical distribution infrastructure to support the delivery model;

- constrained manufacturing costs of conventional portable oxygen concentrators, driven by home medical equipment provider preference for products that have lower upfront equipment cost; and

- limitations of conventional portable oxygen concentrators, including bulkiness, poor reliability and lack of suitability beyond intermittent or travel use.

Our solution

Our Inogen One systems provide patients who require long-term oxygen therapy with a reliable, lightweight, single solution product that improves quality-of-life, fosters mobility and eliminates dependence on both oxygen tanks and cylinders as well as stationary concentrators. We believe our direct-to-consumer strategy increases our ability to effectively develop, design and market our Inogen One solutions, as it allows us to:

- drive patient awareness of our portable oxygen concentrators through direct marketing, sidestepping the home medical equipment channel that other manufacturers rely upon and that is incentivized to continue to service oxygen patients through the delivery model;

- capture the manufacturer and home medical equipment provider margins, allowing us to focus on the total cost of the solution and to invest in the development of product features that improve patient satisfaction, product reliability, durability and longevity; and

Table of Contents

access and utilize direct patient feedback in our research and development efforts, allowing us to stay at the forefront of patient preference. Our two product offerings, the Inogen One G3 and Inogen One G2, at approximately 4.8 and 7.0 pounds, respectively, offer portability without compromising or constraining other patient-friendly features. We believe our Inogen One solutions offer the following benefits:

- single solution for home, ambulatory, travel and nocturnal treatment, meaning our portable oxygen concentrators do not need to be used with another oxygen solution in the home;
- patented air-dryer and patent-pending user-replaceable sieve beds, both of which are critical to patient satisfaction, product performance, and our cost management;
- clinical validation for nocturnal use, demonstrating the efficacy of our Intelligent Delivery Technology in providing consistent levels of oxygen during sleep despite decreased patient respiratory rates;
- our 4.8 pound Inogen One G3 has at least 50% more flow capacity than other sub-5 pound portable oxygen concentrators, and our 7.0 pound Inogen One G2 has at least 15% more flow capacity than other sub-10 pound portable oxygen concentrators; and
- our systems are designed with multiple user friendly features, including long battery life and low noise-levels in their respective weight categories.

Our strengths

We believe our products and business model position us well to compete not only against other oxygen device manufacturers, but also to increase our share of the overall oxygen therapy market. We believe we have the following advantages relative to both traditional oxygen therapy providers and other oxygen device manufacturers:

Attractive economic model. Our non-delivery model allows us to receive a premium monthly Medicare reimbursement for deployment of our devices to oxygen patients versus the delivery model. Standard Medicare reimbursement for ambulatory patients using the delivery model is $208.21 per month versus $229.87 per month for our portable oxygen concentrator model, representing a premium of $21.66 per month. A similar premium was maintained in the round one recompete ($19.09 per month) and in the round two ($23.30 per month) competitive bidding areas. In addition, we believe our portable oxygen concentrator technology and direct-to-consumer strategy allow us to provide our solutions through a more efficient cost structure. The delivery model requires ongoing gaseous or liquid oxygen container refills and regular home deliveries with accompanying costs, while our portable oxygen concentrator non-delivery model eliminates oxygen container refills and regular deliveries of oxygen containers and their associated costs. Following the first two rounds of competitive bidding and the round one recompete, we retained access to approximately 90% of the U.S. long-term oxygen therapy market, with the majority of contracts through mid-2016, while many providers were priced out of this market.

Direct-to-consumer capabilities. We believe our direct-to-consumer strategy enables patient access and retention as well as innovation and investment in our product portfolio. Pursuing a direct-to-consumer strategy requires national accreditation, state-by-state licensing and

Table of Contents

Medicare billing privileges. Given that we are unaware of any manufacturing competitor that currently markets on a direct-to-consumer basis, we do not believe any of these manufacturers possesses the necessary qualification to do so. If any of our manufacturing competitors were to pursue a direct-to-consumer strategy, they would risk negative reaction from the home medical equipment providers that sell their other homecare products, which generally represent significantly larger portions of their businesses than oxygen therapy products.

Commitment to customer service. We are focused on providing our patients with the highest quality of customer service. We guide them through the reimbursement and physician paperwork process, perform clinical titration and offer 24/7 telephone support, which includes clinical support as required. We have a sustained patient satisfaction rating of approximately 95%, as measured by our customer satisfaction surveys.

Patient-friendly, single-solution, sub-5 and sub-10 pound portable oxygen concentrators. Our Inogen One G3 and Inogen One G2 portable oxygen concentrators are sub-5 and sub-10 pound portable oxygen concentrators that can operate reliably and cost-effectively to service long-term oxygen therapy patients on a 24/7 basis, similar to a stationary oxygen concentrator or replacement portable oxygen concentrators. We believe the technology in our Inogen One portable oxygen concentrators is effective for nocturnal use, allowing patients to receive oxygen therapy around the clock from a single device.

Commitment to research and development and developing intellectual property portfolio. We have a broad patent portfolio covering the design and construction of our oxygen concentrators and system optimization. Additionally, we have made significant investments in research and development and have a robust product pipeline of next-generation oxygen concentrators.

Management team with proven track record and cost focus. Our management team has built our direct-to-consumer capabilities and launched our two current primary product offerings, Inogen One G2 and Inogen One G3. We continue to realize meaningful product manufacturing cost savings of approximately 36% from our Inogen One G1 to our Inogen One G3 as a result of management s improvements in design, sourcing and reliability, as well as higher production volumes.

Revenue growth, profitability and recurring revenue. We have grown our revenue from $10.7 million in 2009 to $48.6 million in 2012, representing a year-over-year growth rate of 58.8%. In 2012, our recurring rental revenue represented 40.9% of sales. Our net loss was $2.6 million in 2009 transitioning to net income of $0.6 million in 2012.

Our strategy

Our goal is to design, build and market oxygen solutions that redefine how oxygen therapy is delivered. To accomplish this goal, we will continue to invest in our product offerings and our commercial infrastructure to:

expand our sales and marketing channels, including more internal and physician-based salespeople, increased direct-to-consumer advertising and greater international distribution;

develop innovative products, including next-generation oxygen concentrators and other innovations that improve quality of life;

Table of Contents

secure contracts with private payors and Medicaid in order to become in-network with non-Medicare payors, which represent at least 30% of our home oxygen therapy patients, and we believe represent a younger and more active patient population; and

continue to focus on cost reduction through scalable manufacturing, reliability improvements, asset utilization and service cost reduction.

Risks associated with our business

Our ability to implement our business strategy is subject to numerous risks that you should be aware of before making an investment decision. These risks are described more fully in the section entitled Risk factors immediately following this prospectus summary. These risks include, among others:

A significant majority of our customers have health coverage under the Medicare program, and recently enacted and future changes in the reimbursement rates or payment methodologies under Medicare and other government programs have and could continue to materially and adversely affect our business and operating results;

The implementation of the competitive bidding process under Medicare could negatively affect our business and financial condition;

We face intense national, regional and local competition and if we are unable to compete successfully, it could have an adverse effect on our revenue, revenue growth rate, if any, and market share;

If we are unable to continue to enhance our existing products, develop and market new products that respond to customer needs and preferences and achieve market acceptance, we may experience a decrease in demand for our products and our business could suffer;

If we fail to expand and maintain an effective sales force or successfully develop our international distribution network, our business, financial condition and operating results may be adversely affected; and

If we are unable to secure and maintain patent or other intellectual property protection for the intellectual property used in our products, we will lose a significant competitive advantage.

Corporate history and information

We were incorporated in Delaware in November 2001. Our principal executive offices are located at 326 Bollay Drive, Goleta, California 93117. Our telephone number is (805) 562-0500. Our website address is *www.inogen.com*. Information contained on the website is not incorporated by reference into this prospectus, and should not be considered to be part of this prospectus.

We use Inogen, Inogen One, Inogen One G2, Inogen One G3, oxygen.anytime.anywhere and other marks as trademarks in the United States other countries. This prospectus contains references to our trademarks and service marks and to those belonging to other entities. Solely for convenience, trademarks and trade names referred to in this prospectus, including logos, artwork and other visual displays, may appear without the ® or symbols, but such references are not intended to indicate in any way that we will not assert, to

Table of Contents

the fullest extent under applicable law, our rights or the rights of the applicable licensor to these trademarks and trade names. We do not intend our use or display of other entities trade names, trademarks or service marks to imply a relationship with, or endorsement or sponsorship of us by, any other entity.

Table of Contents

The offering

Common stock offered by us	3,529,411 shares
Common stock offered by the selling stockholders	882,352 shares (or 1,544,116 shares if the underwriters exercise their option to purchase additional shares from the selling stockholders in full)
Common stock to be outstanding after this offering	18,048,936 shares
Use of proceeds	We intend to use the net proceeds from this offering for investments in rental assets; sales and marketing activities; research and product development activities; for facilities improvements or expansions and the purchase of manufacturing and other equipment; and for working capital and other general corporate purposes. We may also use a portion of our net proceeds to acquire and invest in complementary products, technologies or businesses; however, we currently have no agreements or commitments to complete any such transaction. We will not receive any of the net proceeds from the sale of shares of common stock by the selling stockholders. See Use of proceeds.
Risk factors	You should read the Risk factors section of this prospectus for a discussion of factors to consider carefully before deciding to invest in shares of our common stock.
Proposed NASDAQ Global Market symbol	INGN

The number of shares of common stock to be outstanding following this offering is based on 14,519,525 shares of common stock outstanding as of September 30, 2013 and excludes:

2,079,338 shares of common stock issuable upon exercise of options outstanding, 1,466,789 of which were vested and then exercisable, at a weighted average exercise price of $1.0876 per share;

276,334 shares of common stock issuable upon the exercise of options to purchase common stock granted after September 30, 2013, at a weighted average exercise price of $8.37 per share;

1,074,415 shares of common stock reserved for future grants under our stock-based compensation plans as of the date of this prospectus, consisting of:

895,346 shares of common stock reserved for future grants under our 2014 Equity Incentive Plan, which will become effective immediately prior to the date of this prospectus, and any shares subject to stock options under our 2012 Equity Incentive Plan or our 2002 Amended Stock Incentive Plan that expire or otherwise terminate without having been exercised in

Table of Contents

full and any shares issued pursuant to awards granted under such plans that are forfeited to or repurchased by us, with the maximum number of shares to be added to the 2014 Equity Incentive Plan equal to 2,328,569 shares;

179,069 shares of common stock reserved for future issuance under our 2014 Employee Stock Purchase Plan, which will become effective immediately prior to the date of this prospectus; and

Any shares of common stock that become available subsequent to this offering under our 2014 Equity Incentive Plan and 2014 Employee Stock Purchase Plan pursuant to the provisions thereof that automatically increase the shares reserved for issuance under such plans each year, as more fully described in Executive compensation Employee benefit and stock plans; and

268,200 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2013, at a weighted average exercise price of $1.4216 per share, after conversion of the convertible preferred stock.

Unless otherwise indicated, this prospectus reflects and assumes the following:

the conversion of all outstanding shares of our convertible preferred stock into an aggregate of 14,218,319 shares of common stock upon the closing of this offering;

the cash exercise of warrants to purchase an aggregate of 24,588 shares of common stock at a weighted average exercise price of $10.1635 per share, which we expect will occur prior to the closing of this offering as the warrants will otherwise expire at that time;

the filing of our amended and restated certificate of incorporation immediately upon the closing of this offering; and

no exercise by the underwriters of their option to purchase additional shares.

On November 12, 2013, we effected a three-for-one reverse stock split of our outstanding common and preferred stock. This prospectus gives retroactive effect to the split for all periods presented.

Table of Contents

Summary financial data

We have derived the following summary of statements of operations data for the years ended December 31, 2011 and 2012 from audited financial statements appearing elsewhere in this prospectus. We derived the following statements of operations data for the nine months ended September 30, 2012 and 2013 and the balance sheet data as of September 30, 2013 from unaudited interim financial statements included elsewhere in this prospectus. In the opinion of management, the unaudited financial statements reflect all adjustments, which include only normal recurring adjustments necessary for a fair statement of results of operations and financial position. Historical results are not necessarily indicative of the results that may be expected in the future and the results for the nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the full year. The summary financial data set forth below should be read together with the financial statements and the related notes to those statements, as well as the sections of this prospectus captioned Management s discussion and analysis of financial condition and results of operations.

(amounts in thousands, except share and per share amounts)	Year ended December 31, 2011	Year ended December 31, 2012	Nine months ended September 30, 2012	Nine months ended September 30, 2013
		(as restated)	(unaudited)	
Statements of operations:				
Total revenue	$ 30,634	$ 48,576	$ 34,735	$ 55,681
Total cost of revenue	15,930	24,627	17,821	26,865
Gross profit	14,704	23,949	16,914	28,816
Operating expenses				
Research and development	1,789	2,262	1,731	1,817
Selling, general and administrative	14,637	20,858	14,558	23,088
Total operating expenses	16,426	23,120	16,289	24,905
Income (loss) from operations	(1,722)	829	625	3,911
Total other income (expense), net	(267)	(247)	(149)	(296)
Provision for income taxes	13	18	20	151
Net (loss) income	$ (2,002)	$ 564	$ 456	$ 3,464
Less deemed dividend on redeemable convertible preferred stock	$ (3,027)	$ (5,781)	$ (4,119)	$ (5,359)
Net loss attributable to common stockholders	$ (5,029)	$ (5,217)	$ (3,663)	$ (1,895)
Net loss per share attributable to common stockholders basic and diluted(1)	$ (20.15)	$ (19.97)	$ (14.02)	$ (6.91)
Weighted average shares used in computing basic and diluted net loss per share(1)	249,519	261,268	261,216	274,357
Unaudited pro forma net income per share attributable to common stockholders(1):				
Basic:		$ 0.04		$ 0.24
Diluted:		$ 0.04		$ 0.21
Unaudited weighted average shares used in computing pro forma net income per share(1):				
Basic:		14,601,861		14,516,523
Diluted:		15,486,487		16,350,527

Other financial data:				
EBITDA(2)	$ 1,357	$ 5,971	$ 4,224	$ 9,913
Adjusted EBITDA(2)	$ 1,620	$ 5,883	$ 4,124	$ 10,231

Table of Contents

(1) See note 2 to each of our audited and unaudited financial statements included elsewhere in this prospectus for an explanation of the calculations of our basic and diluted net loss per share attributable to common stockholders and pro forma net loss per share attributable to common stockholders.

(2) For a discussion of our use of EBITDA and Adjusted EBITDA and their calculations, please see Non GAAP financial measures below.

	As of September 30, 2013		
			Pro forma as
(in thousands)	**Actual**	**Pro forma(1)**	**adjusted(2)(3)**
		(unaudited)	
Balance sheet data:			
Cash and cash equivalents	$ 17,059	$ 17,309	$ 70,739
Working capital	12,352	12,602	60,032
Total assets	60,862	61,112	114,542
Preferred stock warrant liability	201	173	173
Total liabilities	26,667	26,639	26,639
Redeemable convertible preferred stock	116,744		
Preferred Stock	247		
Common Stock	1	15	19
Additional paid in capital		117,255	170,681
Total stockholders (deficit) equity	(82,549)	34,473	87,903

(1) Gives effect to (i) the conversion of all outstanding shares of convertible preferred stock into an aggregate of 14,218,319 shares of common stock upon the closing of this offering, (ii) the cash exercise of warrants to purchase an aggregate of 24,588 shares of common stock, which we expect will occur prior to the closing of this offering as the warrants will otherwise expire at that time, and (iii) the reclassification of our preferred stock warrant liability to additional paid-in-capital upon the closing of this offering.

(2) Gives further effect to our sale of 3,529,411 shares of common stock in this offering at an assumed initial public offering price of $17.00 per share, the midpoint of the range reflected on the cover page of this prospectus, after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

(3) A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share, the midpoint of the price range reflected on the cover page of this prospectus, would increase (decrease) each of pro forma as adjusted cash and cash equivalents, working capital, total assets and total stockholders equity by approximately $3.28 million, assuming that the number of shares offered by us, as set forth on the cover of this prospectus, remains the same and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us. A 1,000,000 share increase (decrease) in the number of shares offered by us would increase (decrease) each of pro forma as adjusted cash and cash equivalents, working capital, total assets and total stockholders equity by approximately $15.81 million after deducting estimated underwriting discounts and commissions and any estimated offering expenses payable by us.

Non-GAAP financial measures

EBITDA and Adjusted EBITDA are financial measures that are not calculated in accordance with generally accepted accounting principles in the United States, or GAAP. We define EBITDA as net income or loss excluding interest income, interest expense, taxes and depreciation and amortization. Adjusted EBITDA also excludes the change in the fair value of our preferred stock warrant liability and stock-based compensation. Below, we have provided a reconciliation of EBITDA and Adjusted EBITDA to our net income or loss, the most directly comparable financial measure calculated and presented in accordance with GAAP. EBITDA and Adjusted EBITDA should not be considered as alternatives to net income or loss or any other measure of financial performance calculated and presented in accordance with GAAP. Our EBITDA and Adjusted EBITDA may not be comparable to similarly titled measures of other organizations because other organizations may not calculate EBITDA and Adjusted EBITDA in the same manner as we calculate these measures.

Table of Contents

We include EBITDA and Adjusted EBITDA in this prospectus because they are important measures upon which our management assesses our operating performance. We use EBITDA and Adjusted EBITDA as key performance measures because we believe they facilitate operating performance comparisons from period to period by excluding potential differences primarily caused by variations in capital structures, tax positions, the impact of depreciation and amortization expense on our fixed assets, changes related to the fair value remeasurements of our preferred stock warrant, and the impact of stock-based compensation expense. Because EBITDA and Adjusted EBITDA facilitate internal comparisons of our historical operating performance on a more consistent basis, we also use EBITDA and Adjusted EBITDA for business planning purposes, to incentivize and compensate our management personnel, and in evaluating acquisition opportunities. In addition, we believe EBITDA and Adjusted EBITDA and similar measures are widely used by investors, securities analysts, ratings agencies, and other parties in evaluating companies in our industry as a measure of financial performance and debt-service capabilities.

Our use of EBITDA and Adjusted EBITDA have limitations as analytical tools, and you should not consider them in isolation or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

- EBITDA and Adjusted EBITDA do not reflect our cash expenditures for capital equipment or other contractual commitments;
- Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and EBITDA and Adjusted EBITDA do not reflect capital expenditure requirements for such replacements;
- EBITDA and Adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital needs;
- EBITDA and Adjusted EBITDA do not reflect the interest expense or the cash requirements necessary to service interest or principal payments on our indebtedness; and
- Other companies, including companies in our industry, may calculate EBITDA and Adjusted EBITDA measures differently, which reduces their usefulness as a comparative measure.

In evaluating EBITDA and Adjusted EBITDA, you should be aware that in the future we will incur expenses similar to the adjustments in this presentation. Our presentation of EBITDA and Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by these expenses or any unusual or non-recurring items. When evaluating our performance, you should consider EBITDA and Adjusted EBITDA alongside other financial performance measures, including our net loss and other GAAP results.

Table of Contents

The following table presents a reconciliation of EBITDA and Adjusted EBITDA to our net income or loss, the most comparable GAAP measure, for each of the periods indicated:

EBITDA and adjusted EBITDA (in thousands)	Year ended December 31, 2011	Year ended December 31, 2012	Nine months ended September 30, 2012	Nine months ended September 30, 2013
Net income (loss)	$ (2,002)	$ 564	$ 456	$ 3,464
Non-GAAP adjustments:				
Interest income	(113)	(88)	(84)	(9)
Interest expense	261	493	381	312
Provision for income taxes	13	18	20	151
Depreciation and amortization	3,198	4,984	3,451	5,995
EBITDA	1,357	5,971	4,224	9,913
Change in fair value of preferred stock warrant liability	119	(148)	(148)	202
Stock-based compensation	144	60	48	116
Adjusted EBITDA	$ 1,620	$ 5,883	$ 4,124	$ 10,231

Table of Contents

Risk factors

Investing in our common stock involves a high degree of risk. You should consider carefully the risks and uncertainties described below, together with all of the other information in this prospectus, including our financial statements and related notes, before deciding whether to purchase shares of our common stock. If any of the following risks are realized, our business, financial condition, results of operations and prospects could be materially and adversely affected. In that event, the price of our common stock could decline and you could lose part or all of your investment.

Risks related to our business and strategy

A significant majority of our customers have health coverage under the Medicare program, and recently enacted and future changes in the reimbursement rates or payment methodologies under Medicare and other government programs have affected and could continue to materially and adversely affect our business and operating results.

As a provider of oxygen product rentals, we have historically depended heavily on Medicare reimbursement as a result of the higher proportion of elderly persons suffering from chronic respiratory conditions. Medicare Part B, or Supplementary Medical Insurance Benefits, provides coverage to eligible beneficiaries that includes items of durable medical equipment for use in the home, such as oxygen equipment and other respiratory devices. We believe that more than 60% of oxygen therapy patients in the United States have primary coverage under Medicare Part B. In 2011 and 2012, we derived approximately 26% and 27%, respectively, of our revenue from Medicare. There are increasing pressures on Medicare to control health care costs and to reduce or limit reimbursement rates for home medical products.

Legislation, including the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, the Deficit Reduction Act of 2005, the Medicare Improvements for Patients and Providers Act of 2008, and the Patient Protection and Affordable Care Act, contain provisions that directly impact reimbursement for the durable medical equipment products provided by us:

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 significantly reduced reimbursement for inhalation drug therapies beginning in 2005, reduced payment amounts for certain durable medical equipment, including oxygen, beginning in 2005, froze payment amounts for other covered home medical equipment items through 2008, established a competitive bidding program for home medical equipment and implemented quality standards and accreditation requirements for durable medical equipment suppliers.

The Deficit Reduction Act of 2005 limited the total number of continuous rental months for which Medicare will pay for oxygen equipment to 36 months, after which time there is generally no additional reimbursement to the supplier (other than for periodic, in-home maintenance and servicing). The Deficit Reduction Act of 2005 also provided that title of the equipment would transfer to the beneficiary, which was later repealed by the Medicare Improvements for Patients and Providers Act of 2008. For purposes of the rental cap, the Deficit Reduction Act of 2005 provided for a new 36-month rental period that began January 1, 2006 for all oxygen equipment. After the 36th continuous month during which payment is made for the oxygen equipment, the supplier is generally required to continue to furnish the equipment during the period of medical need for the remainder of the useful lifetime of the equipment, provided there are no breaks in service due to medical necessity that exceed 60 days. The reasonable useful lifetime for portable oxygen equipment is 60 months. After 60 months, if the

Table of Contents

patient requests, the rental cycle starts over and a new 36-month capped rental period begins. There are no limits on the number of 60-month cycles over which a Medicare patient may receive benefits and an oxygen therapy provider may receive reimbursement, so long as such equipment continues to be medically necessary for the patient. We anticipate that the Deficit Reduction Act of 2005 oxygen payment rules will continue to negatively affect our net revenue on an ongoing basis, as each month additional customers reach the 36-month capped service period, resulting in potentially two or more years without rental income from these customers. We cannot state with certainty the number of patients in the capped rental period or the potential impact to revenue associated with patients in the capped rental period.

Medicare Improvements for Patients and Providers Act of 2008 retroactively delayed the implementation of competitive bidding for 18 months from previously established dates and decreased the 2009 fee schedule payment amounts by 9.5% for product categories included in competitive bidding. In addition to the 9.5% reduction under Medicare Improvements for Patients and Providers Act of 2008, the Centers for Medicare & Medicaid Services implemented a reduction to the monthly payment amount for stationary oxygen equipment by 2.3% in 2009 and 1.5% in 2010, which reduced the monthly payment rate to $175.79 and $173.17 in 2009 and 2010, respectively. The stationary oxygen payment rate for 2011 and 2012 was increased by 0.1%, 1.6%, and 0.7% in 2011, 2012, and 2013, respectively, thereby increasing the monthly payment rate to $173.31, $176.06, and $177.36 in 2011, 2012, and 2013, respectively. The monthly payment rate for non-delivery ambulatory oxygen in the relevant period was flat at $51.63.

The Patient Protection and Affordable Care Act includes, among other things, a deductible excise tax on any entity that manufactures or imports medical devices offered for sale in the United States, with limited exceptions including oxygen products such as ours, which began in 2013; new face-to-face physician encounter requirements for durable medical equipment and home health services; and a requirement that by 2016, the competitive bidding process must be nationalized or prices in non-competitive bidding areas must be adjusted to match competitive bidding prices.

These legislative provisions, as currently in effect and when fully implemented, have had and will continue to have a material and adverse effect on our business, financial condition and operating results.

Due to budgetary shortfalls, many states are considering, or have enacted, cuts to their Medicaid programs. These cuts have included, or may include, elimination or reduction of coverage for our products, amounts eligible for payment under co-insurance arrangements, or payment rates for covered items. Continued state budgetary pressures could lead to further reductions in funding for the reimbursement for our products which, in turn, would adversely affect our business, financial conditions, and results of operations.

The implementation of the competitive bidding process under Medicare could negatively affect our business and financial condition.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 required the Secretary of Health and Human Services to establish and implement programs under which competitive acquisition areas are established throughout the United States for purposes of awarding contracts for the furnishing of competitively priced items of durable medical equipment, including oxygen equipment.

Table of Contents

The Centers for Medicare & Medicaid Services, the agency responsible for administering the Medicare program, conducts a competition for each competitive acquisition area under which providers submit bids to supply certain covered items of durable medical equipment. Successful bidders must meet certain program quality standards in order to be awarded a contract and only successful bidders can supply the covered items to Medicare beneficiaries in the acquisition area. There are, however, regulations in place that allow non-contracted providers to continue to provide products and services to their existing customers at the new competitive bidding payment amounts. The contracts are expected to be re-bid every three years. The Centers for Medicare & Medicaid Services is required to award contracts to multiple entities submitting bids in each area for an item or service, but has the authority to limit the number of contractors in a competitive acquisition area to the number it determines to be necessary to meet projected demand.

Although the Centers for Medicare & Medicaid Services concluded the bidding process for the first round of Metropolitan Statistical Areas in September 2007, in July 2008, Congress enacted Medicare Improvements for Patients and Providers Act of 2008, which retroactively delayed the implementation of competitive bidding. Medicare Improvements for Patients and Providers Act of 2008 also reduced Medicare prices nationwide by 9.5% beginning in 2009 for the product categories, including oxygen, that were initially included in competitive bidding.

In 2009, the Centers for Medicare & Medicaid Services implemented a new bidding process in nine Metropolitan Statistical Areas, covering approximately 9% of the Medicare oxygen market. Reimbursement rates from the re-bidding process were publicly released by the Centers for Medicare & Medicaid Services on June 30, 2010. The Centers for Medicare & Medicaid Services announced average savings of approximately 35% off the current standard Medicare payment rates in effect for the product categories included in competitive bidding. As of January 1, 2011, these payment rates were in effect in the nine markets only. We were offered six three-year contracts to provide oxygen equipment in six of the nine markets, and we accepted and signed those contracts.

The Centers for Medicare & Medicaid Services implemented the second phase of competitive bidding in an additional 100 competitive bidding areas covering approximately 50% of the Medicare oxygen market, with three-year contracts effective July 1, 2013. The Centers for Medicare & Medicaid Services announced average savings of approximately 45% off the current standard Medicare payment rates in effect for the product categories included in competitive bidding. As of July 1, 2013, these payment rates were in effect in the 100 competitive bidding areas. We were offered 89 contracts to provide oxygen equipment in 89 of the 100 Competitive Bidding Areas, and we accepted and signed those contracts.

Round one re-competes are expected or planned to go into effect in January 2014; reimbursement rates from the re-bidding process were publicly released by the Centers for Medicare & Medicaid Services on October 1, 2013. The Centers for Medicare & Medicaid Services announced average savings of approximately 37% off the current standard Medicare payment rates in effect from the product categories included in competitive bidding. We were offered 3 contracts to provide respiratory equipment in 3 of the 9 competitive bidding areas, and we accepted and signed those contracts. We are required to be able to supply additional respiratory products such as sleep and aerosol therapy, which have lower margins than our existing products. This could have a negative impact on our financial conditions and results of operations.

Table of Contents

The Patient Protection and Affordable Care Act legislation requires the Centers for Medicare & Medicaid Services to expand competitive bidding further to additional geographic markets or to use competitive bid pricing information to adjust the payment amounts otherwise in effect for areas that are not competitive acquisition areas by January 1, 2016.

Although we continue to monitor developments regarding the implementation of the competitive bidding program, we cannot predict the outcome of the competitive bidding program on our business when fully implemented, nor the Medicare payment rates that will be in effect in future years for the items subjected to competitive bidding, including our products. We expect that the stationary oxygen and non-delivery ambulatory oxygen payment rates will continue to fluctuate, and a large negative payment adjustment could adversely affect our business, financial conditions and results of operations.

We face intense national, regional and local competition and if we are unable to compete successfully, it could have an adverse effect on our revenue, revenue growth rate, if any, and market share.

The oxygen therapy market is a highly competitive industry. We compete with a number of manufacturers and distributors of portable oxygen concentrators, as well as providers of other oxygen therapy solutions such as home delivery of oxygen tanks or cylinders.

Our significant manufacturing competitors are Invacare Corporation, Respironics (a subsidiary of Koninklijke Philips N.V.), AirSep Corporation and SeQual Technologies (subsidiaries of Chart Industries, Inc.), Inova Labs, Inc. and DeVilbiss Healthcare. Given the relatively straightforward regulatory path in the oxygen therapy device manufacturing market, we expect that the industry will become increasingly competitive in the future. Manufacturing companies compete for sales to providers primarily on the basis of product features, service and price.

Lincare Inc., Apria Healthcare, Inc. Rotech Healthcare, Inc. and American HomePatient, Inc. are among the market leaders in providing oxygen therapy for many years, while the remaining oxygen therapy market is serviced by local providers. Because many oxygen therapy providers were either excluded from contracts in the Medicare competitive bidding process, or will have difficulty providing service at the prevailing Medicate reimbursement rates, we expect more industry consolidation. Oxygen therapy providers compete primarily on the basis of product features and service, rather than price, since reimbursement levels are established by Medicare and Medicaid, or by the individual determinations of private payors.

Some of our competitors are large, well-capitalized companies with greater resources than we have. As a consequence, they are able to spend more aggressively on product development, marketing, sales and other product initiatives than we can. Some of these competitors have:

- significantly greater name recognition;
- established relations with healthcare professionals, customers and third-party payors;
- established distribution networks;
- additional lines of products, and the ability to offer rebates or bundle products to offer higher discounts or other incentives to gain a competitive advantage;
- greater history in conducting research and development, manufacturing, marketing and obtaining regulatory approval for oxygen device products; and

Table of Contents

greater financial and human resources for product development, sales and marketing, patent litigation and customer financing.

As a result, our competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standard regulatory and reimbursement development and customer requirements. In light of these advantages that our competitors maintain, even if our technology and direct-to-consumer distribution strategy is more effective than the technology and distribution strategy of our competitors, current or potential customers might accept competitor products and services in lieu of purchasing our products. We anticipate that we will face increased competition in the future as existing companies and competitors develop new or improved products and distribution strategies and as new companies enter the market with new technologies and distribution strategies. We may not be able to compete effectively against these organizations. Our ability to compete successfully and to increase our market share is dependent upon our reputation for providing responsive, professional and high-quality products and services and achieving strong customer satisfaction. Increased competition in the future could adversely affect our revenue, revenue growth rate, margins and market share.

Healthcare reform measures may have a material adverse effect on our business and results of operations.

In the United States, the legislative landscape, particularly as it relates to healthcare regulation and reimbursement coverage, continues to evolve. In March 2010, the Patient Protection and Affordable Care Act was passed, which has the potential to substantially change health care financing by both governmental and private insurers, and significantly impact the U.S. medical device industry. As discussed above, the Patient Protection and Affordable Care Act, among other things, imposes a new excise tax, which began in 2013, on entities that manufacture, produce or import medical devices in an amount equal to 2.3% of the price for which such devices are sold in the United States, however oxygen products such as ours were exempt. In addition, as discussed above, the Patient Protection and Affordable Care Act also expands the round two of competitive bidding to a total of 91 competitive bidding areas, and by 2016, the process must be nationalized or prices in non-competitive bidding areas must be adjusted to match competitive bidding prices.

In addition, other legislative changes have been proposed and adopted in the United States since the Patient Protection and Affordable Care Act was enacted. On August 2, 2011, the Budget Control Act of 2011 among other things, created measures for spending reductions by Congress. A Joint Select Committee on Deficit Reduction, tasked with recommending a targeted deficit reduction of at least $1.2 trillion for the years 2013 through 2021, was unable to reach required goals, thereby triggering the legislation s automatic reduction to several government programs. This includes aggregate reductions of Medicare payments to providers up to 2% per fiscal year, which went into effect on April 1, 2013. On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 which, among other things, further reduced Medicare payments to certain providers, including physicians, hospitals, imaging centers and cancer treatment centers, and increased the statute of limitations period for the government to recover overpayments to providers from three to five years. We expect that additional state and federal healthcare reform measures will be adopted in the future, any of which could limit the amounts that federal and state governments will pay for healthcare products and services, which could result in reduced demand for our products or additional pricing pressures.

Table of Contents

If we are unable to continue to enhance our existing products and develop and market new products that respond to customer needs and preferences and achieve market acceptance, we may experience a decrease in demand for our products and our business could suffer.

We may not be able to compete as effectively with our competitors, and ultimately satisfy the needs and preferences of our customers, unless we can continue to enhance existing products and develop new innovative products. Product development requires significant financial, technological, and other resources. While we expended $1.8 million and $2.3 million for research and development efforts in 2011 and 2012, respectively, we cannot assure you that this level of investment in research and development will be sufficient to maintain a competitive advantage in product innovation, which could cause our business to suffer. Product improvements and new product introductions also require significant planning, design, development, and testing at the technological, product, and manufacturing process levels and we may not be able to timely develop product improvements or new products. Our competitors new products may beat our products to market, be more effective with more features, obtain better market acceptance, or render our products obsolete. Any new products that we develop may not receive market acceptance or otherwise generate any meaningful sales or profits for us relative to our expectations based on, among other things, existing and anticipated investments in manufacturing capacity and commitments to fund advertising, marketing, promotional programs, and research and development.

We depend upon reimbursement from Medicare, private payors and Medicaid for a significant portion of our revenue, and if we fail to manage the complex and lengthy reimbursement process, our business and operating results could suffer.

A significant portion of our revenue is derived from reimbursement by third-party payors. We accept assignment of insurance benefits from customers and, in a majority of cases, invoice and collect payments directly from Medicare, private payors and Medicaid, as well as from customers under co-payment provisions. In 2012, approximately 41% of our revenue was derived from Medicare, private payors and Medicaid, and the balance directly from individual customers and commercial entities.

Our financial condition and results of operations may be affected by the health care industry s reimbursement process, which is complex and can involve lengthy delays between the time that a product is delivered to the consumer and the time that the reimbursement amounts are settled. Depending on the payor, we may be required to obtain certain payor-specific documentation from physicians and other health care providers before submitting claims for reimbursement. Certain payors have filing deadlines and they will not pay claims submitted after such time. We are also subject to extensive pre-payment and post-payment audits by governmental and private payors that could result in material delays, refunds of monies received or denials of claims submitted for payment under such third-party payor programs and contracts. We cannot ensure that we will be able to continue to effectively manage the reimbursement process and collect payments for our products promptly. If we fail to manage the complex and lengthy reimbursement process, it would adversely affect our business, financial conditions, and results of operations.

Table of Contents

Failure to obtain private payor contracts and future reductions in reimbursement rates from private payors could have a material adverse effect on our financial condition and operating results.

A portion of our revenue is derived from private payors. Based on our patient population, we estimate at least 30% of potential customers have non-Medicare insurance coverage, and we believe these patients represent a younger and more active patient population that will be drawn to the quality-of-life benefits of our solution. Failing to maintain and obtain private payor contracts from private insurance companies and employers and secure in-network provider status could have a material adverse effect on our financial condition and operating results. In addition, private payors are under pressure to increase profitability and reduce costs. In response, certain private payors are limiting coverage or reducing reimbursement rates for the products we provide. We believe that private payor reimbursement levels will generally be reset in accordance with the Medicare payment amounts determined by competitive bidding. We cannot predict the extent to which reimbursement for our products will be affected by competitive bidding or by initiatives to reduce costs for private payors. Failure to obtain or maintain private payor contracts or the unavailability of third-party coverage or inadequacy of reimbursement for our products would adversely affect our business, financial conditions, and results of operations.

We obtain some of the components, subassemblies and completed products included in our Inogen One systems from a single source or a limited group of manufacturers or suppliers, and the partial or complete loss of one of these manufacturers or suppliers could cause significant production delays, an inability to meet customer demand and a substantial loss in revenue.

We utilize single source suppliers for some of the components and subassemblies we use in our Inogen One systems. We have qualified alternate sources of supply sufficient to support future needs and we have taken other mitigating steps to reduce the impact of a change in supplier; however, there may be delays in switching to these alternative suppliers if our primary source is terminated without notice. Our dependence on single source suppliers of components may expose us to several risks, including, among other things:

Our suppliers may encounter financial hardships as a result of unfavorable economic and market conditions unrelated to our demand for components, which could inhibit their ability to fulfill our orders and meet our requirements;

Suppliers may fail to comply with regulatory requirements, be subject to lengthy compliance, validation or qualification periods, or make errors in manufacturing components that could negatively affect the efficacy or safety of our products or cause delays in supplying of our products to our customers;

Newly identified suppliers may not qualify under the stringent regulatory standards to which our business is subject;

We or our suppliers may not be able to respond to unanticipated changes in customer orders, and if orders do not match forecasts, we or our suppliers may have excess or inadequate inventory of materials and components;

We may be subject to price fluctuations due to a lack of long-term supply arrangements for key components;

We may experience delays in delivery by our suppliers due to changes in demand from us or their other customers;

Table of Contents

We or our suppliers may lose access to critical services and components, resulting in an interruption in the manufacture, assembly and shipment of our systems;

Our suppliers may be subject to allegations by other parties of misappropriation of proprietary information in connection with their supply of products to us, which could inhibit their ability to fulfill our orders and meet our requirements;

Fluctuations in demand for products that our suppliers manufacture for others may affect their ability or willingness to deliver components to us in a timely manner;

Our suppliers may wish to discontinue supplying components or services to us; and

We may not be able to find new or alternative components or reconfigure our system and manufacturing processes in a timely manner if the necessary components become unavailable.

In addition, we may be deemed to manufacture or contract to manufacture products that contain certain minerals that have been designated as conflict minerals under the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a result, in future periods, we may be required to diligence the origin of such minerals and disclose and report whether or not such minerals originated in the Democratic Republic of the Congo or adjoining countries. The implementation of these new requirements could adversely affect the sourcing, availability, and pricing of minerals used in the manufacture of our products. In addition, we may incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the relevant minerals and metals used in our products.

If any of these risks materialize, costs could significantly increase and our ability to meet demand for our products could be impacted. If we are unable to satisfy commercial demand for our Inogen One systems in a timely manner, our ability to generate revenue would be impaired, market acceptance of our products could be adversely affected, and customers may instead purchase or use alternative products. In addition, we could be forced to secure new or alternative components and subassemblies through a replacement supplier. Finding alternative sources for these components and subassemblies could be difficult in certain cases and may entail a significant amount of time and disruption. In some cases, we would need to change the components or subassemblies if we sourced them from an alternative supplier. This, in turn, could require a redesign of our Inogen One systems and, potentially, require additional FDA clearance or approval before we could use any redesigned product with new components or subassemblies, thereby causing further costs and delays that could adversely affect our business, financial condition and operating results.

We do not have long-term supply contracts with many of our third-party suppliers.

We purchase components and subassemblies from third-party suppliers, including some of our single source suppliers, through purchase orders and do not have long-term supply contracts with many of these third-party suppliers. Many of our third-party suppliers, therefore, are not obligated to perform services or supply products to us for any specific period, in any specific quantity or at any specific price, except as may be provided in a particular purchase order. We do not maintain large volumes of inventory from most of these suppliers. If we inaccurately forecast demand for components or subassemblies, our ability to manufacture and commercialize our Inogen One systems could be delayed and our competitive position and reputation could be harmed. In addition, if we fail to effectively manage our relationships with these suppliers, we may be required to change suppliers which would be time consuming and disruptive and could adversely affect our business, financial condition and operating results.

Table of Contents

If we fail to comply with U.S. export control and economic sanctions or fail to expand and maintain an effective sales force or successfully develop our international distribution network, our business, financial condition and operating results may be adversely affected.

We currently derive the majority of our revenue from rentals or sales generated from our own direct sales force. Failure to maintain or expand our direct sales force could adversely impact our financial and operating performance. Additionally, we use international distributors to augment our sales efforts, certain of which are exclusive distributors in certain foreign countries. We cannot assure you that we will be able to successfully develop our relationships with third-party distributors internationally. In addition, we are subject to United States export control and economic sanctions laws relating to the sale of our products, the violation of which could result in substantial penalties being imposed against us. In particular, we have secured annual export licenses from the U.S. Treasury Department s Office of Foreign Assets Control to sell our products to a distributor and hospital and clinic end-users in Iran. The use of this license requires us to observe strict conditions with respect to products sold, end-user limitations and payment requirements. Although we believe we have maintained compliance with license requirements, there can be no assurance that the license will not be revoked, be renewed in the future or that we will remain in compliance. More broadly, if we fail to comply with export control laws or successfully develop our relationship with international distributors, our sales could fail to grow or could decline, and our ability to grow our business could be adversely affected. Distributors that are in the business of selling other medical products may not devote a sufficient level of resources and support required to generate awareness of our products and grow or maintain product sales. If our distributors are unwilling or unable to market and sell our products, or if they do not perform to our expectations, we could experience delayed or reduced market acceptance and sales of our products.

We may be subject to substantial warranty or product liability claims or other litigation in the ordinary course of business that may adversely affect our business, financial condition and operating results.

As manufacturers of medical devices, we may be subject to substantial warranty or product liability claims or other litigation in the ordinary course of business that may require us to make significant expenditures to defend these claims or pay damage awards. For example, our Inogen One systems contain lithium ion batteries, which, under certain circumstances, can be a fire hazard. We, as well as our key suppliers, maintain product liability insurance, but this insurance is limited in amount and subject to significant deductibles. There is no guarantee that insurance will be available or adequate to protect against all claims. Our insurance policies are subject to annual renewal and we may not be able to obtain liability insurance in the future on acceptable terms or at all. In addition, our insurance premiums could be subject to increases in the future, which may be material. If the coverage limits are inadequate to cover our liabilities or our insurance costs continue to increase as a result of warranty or product liability claims or other litigation, then our business, financial condition and operating results may be adversely affected.

Increases in our operating costs could have a material adverse effect on our business, financial condition and operating results.

Reimbursement rates are established by fee schedules mandated by Medicare, private payors and Medicaid are likely to remain constant or decrease due, in part, to federal and state government budgetary constraints. As a result, with respect to Medicare and Medicaid related revenue, we

Table of Contents

are not able to offset the effects of general inflation on our operating costs through increases in prices for our products. In particular, labor and related costs account for a significant portion of our operating costs and we compete with other health care providers to attract and retain qualified or skilled personnel and with various industries for administrative and service employees. This competitive environment could result in increased labor costs. As such, we must control our operating costs, particularly labor and related costs, and failing to do so could adversely affect our financial conditions and results of operations.

We depend on the services of our senior executives and other key technical personnel, the loss of whom could negatively affect our business.

Our success depends upon the skills, experience and efforts of our senior executives and other key technical personnel, including certain members of our engineering staff, and our sales and marketing executives. Much of our corporate expertise is concentrated in relatively few employees, the loss of which for any reason could negatively affect our business. Competition for our highly skilled employees is intense and we cannot prevent the resignation of any employee. We do not maintain key man life insurance on any of our senior executives. None of our senior executive team is bound by written employment contracts to remain with us for a specified period. In addition, we have not entered into non-compete agreements with members of our senior management team. The loss of any member of our senior management team could harm our ability to implement our business strategy and respond to the market conditions in which we operate.

We have incurred losses since inception until fiscal year 2012, and we have only recently achieved profitability.

We have a limited operating history and have incurred significant net losses in each fiscal year until fiscal year 2012, when we achieved positive net income. As of September 30, 2013, we had an accumulated deficit of $82.5 million. These net losses have resulted principally from costs incurred in our research and development programs and from our selling, general and administrative expenses. We expect to incur increases in expenses for research and development and significant expansion of our sales and marketing capabilities. Additionally, following this offering, we expect that our selling, general and administrative expenses will increase due to the additional operational and reporting costs associated with being a public company. Because of the numerous risks and uncertainties associated with our commercialization efforts and future product development, we are unable to predict if we will maintain or increase our net income.

Our financial results may vary significantly from quarter-to-quarter due to a number of factors, which may lead to volatility in our stock price.

Our quarterly revenue and results of operations have varied in the past and may continue to vary significantly from quarter-to-quarter. This variability may lead to volatility in our stock price as research analysts and investors respond to these quarterly fluctuations. These fluctuations are due to numerous factors, including: fluctuations in consumer demand for our products; seasonal cycles in consumer spending; our ability to design, manufacture and deliver products to our consumers in a timely and cost-effective manner; quality control problems in our manufacturing operations; our ability to timely obtain adequate quantities of the components used in our products; new product introductions and enhancements by us and our competitors; unanticipated increases in costs or expenses; and fluctuations in foreign currency exchange rates.

Table of Contents

For example, we typically experience higher sales in the second quarter, as a result of consumers traveling and vacationing during the summer months. The foregoing factors are difficult to forecast, and these, as well as other factors, could materially and adversely affect our quarterly and annual results of operations. In addition, a significant amount of our operating expenses are relatively fixed due to our manufacturing, research and development, and sales and general administrative efforts. Any failure to adjust spending quickly enough to compensate for a revenue shortfall could magnify the adverse impact of such revenue shortfall on our results of operations. Our results of operations may not meet the expectations of research analysts or investors, in which case the price of our common stock could decrease significantly.

The terms of our revolving credit and term loan agreement may restrict our current and future operations, and could affect our ability to respond to changes in our business and to manage our operations.

We are parties to an amended and restated revolving credit and term loan agreement with Comerica Bank as administrative agent, which we refer to as our revolving credit and term loan agreement. The agreement provides for a previously existing term loan in the amount of $3.0 million, another previously existing term loan in the amount of $8.0 million and a new term loan facility in the amount of $12.0 million. As of September 30, 2013, we had term loan borrowings outstanding under the agreement of $11.1 million, which included $0.7 million and $4.4 million under the pre-existing term loans, and $6.0 million under the new term loan. The agreement also provides for a $1.0 million revolving line of credit, none of which was outstanding as of September 30, 2013. The revolver expired on October 13, 2013 and we have no plans to renew or replace it. The agreement is secured by all or substantially all of our assets.

Pursuant to the agreement, we are subject to certain financial covenants relating to liquidity, debt service, and leverage ratios. The liquidity ratio is the ratio of (i) liquidity (cash plus eligible accounts receivable) to (ii) the current portion of all indebtedness owed to the lenders. The debt service coverage ratio is the ratio on a basis of (a) Adjusted EBITDA, less (i) cash capital expenditures (including rental equipment) and (ii) taxes paid or payable, to (b) the sum of cash principal payments plus interest expense paid or payable, all such items in clauses (a) and (b) measured on an annualized trailing six (6) months basis; provided that cash capital expenditures shall not be subtracted from clause (a) hereof so long as we maintain at least $1.5 million in unrestricted cash during the entire relevant fiscal period. The senior leverage ratio is the ratio of (a) funded debt basis to (b) Adjusted EBITDA measured on an annualized trailing six (6) months basis.

The agreement contains events of default customary for transactions of this type, including nonpayment, misrepresentation, breach of covenants, material adverse effect and bankruptcy. As of September 30, 2013, we had no outstanding balance under the revolving line of credit and an outstanding balance of $11.1 million under the term loan. In the event we fail to satisfy our covenants, or otherwise go into default, Comerica Bank has a number of remedies, including sale of our assets and acceleration of all outstanding indebtedness. Certain of these remedies would likely have a material adverse effect on our business. As of September 30, 2013, in order to be in compliance with the liquidity requirements, debt service ratios, and leverage ratios of existing debt obligations, we were required to maintain $2.5 million in unaudited Adjusted EBITDA in the previous six months, and we had $6.6 million in actual unaudited Adjusted EBITDA, and $7.8 million of cash and qualified accounts receivable, and we had $17.1 million of actual cash.

Table of Contents

An adverse outcome of a sales and use tax audit could have a material adverse effect on our results of operations and financial condition.

The California State Board of Equalization conducted a sales and use tax audit of our operations in California in 2008. As a result of the audit, the California State Board of Equalization confirmed that our sales are not subject to California sales and use tax. We believe that our sales in other states should not be subject to sales and use tax. There can be no assurance, however, that other states may agree with our position and we may be subject to an audit that may not be resolved in our favor. Such an audit could be expensive and time-consuming and result in substantial management distraction. If the matter were to be resolved in a manner adverse to us, it could have a material adverse effect on our results of operations and financial position.

Our ability to use net operating losses to offset future taxable income may be subject to certain limitations.

As of December 31, 2012, we had federal net operating loss carryforwards, or NOLs, of approximately $62.0 million, which expire in various years beginning in 2022, if not utilized. In general, under Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, a corporation that undergoes an ownership change is subject to limitations on its ability to utilize its pre-change NOLs to offset future taxable income. In general, an ownership change occurs if there is a cumulative change in our ownership by 5% shareholders that exceeds 50 percentage points over a rolling three-year period. Our existing NOLs may be subject to limitations arising from previous ownership changes, and if we undergo one or more ownership changes in connection with this offering or future transactions in our stock, our ability to utilize NOLs could be further limited by Section 382 of the Code. As a result of these limitations, we may not be able to utilize a material portion of the NOLs reflected on our balance sheet and for this reason, we have fully reserved against the value of our NOLs on our balance sheet.

Risks related to the regulatory environment

We are subject to extensive federal and state regulation, and if we fail to comply with applicable regulations, we could suffer severe criminal or civil sanctions or be required to make significant changes to our operations that could adversely affect our business, financial condition and operating results.

The federal government and all states in which we currently operate regulate various aspects of our business. In particular, our sales and customer service centers are subject to federal laws that regulate interstate motor-carrier transportation. Our operations also are subject to state laws governing, among other things, distribution of medical equipment and certain types of home health activities, and we are required to obtain and maintain licenses in each state to act as a durable medical equipment supplier. Certain of our employees are subject to state laws and regulations governing the professional practices of respiratory therapy.

As a health care provider participating in governmental healthcare programs, we are subject to laws directed at preventing fraud and abuse, which subject our marketing, billing, documentation and other practices to government scrutiny. To ensure compliance with Medicare, Medicaid and other regulations, government agencies or their contractors often conduct routine audits and request customer records and other documents to support our claims submitted for payment of services rendered. Government agencies or their contractors also periodically open investigations and obtain information from health care providers. Violations of federal and state

Table of Contents

regulations can result in severe criminal, civil and administrative penalties and sanctions, including debarment, suspension or exclusion from Medicare, Medicaid and other government reimbursement programs, any of which would have a material adverse effect on our business.

Changes in healthcare laws and regulations and new interpretations of existing laws and regulations may affect permissible activities, the relative costs associated with doing business, and reimbursement amounts paid by federal, state and other third-party payors. There have been and will continue to be regulatory initiatives affecting our business and we cannot predict the extent to which future legislation and regulatory changes could have a material adverse effect on our business.

We are subject to burdensome and complex billing and record-keeping requirements in order to substantiate our claims for payment under Federal, state and commercial health care reimbursement programs, and our failure to comply with existing requirements, or changes in those requirements or interpretations thereof, could adversely affect our business, financial condition and operating results.

We are subject to burdensome and complex billing and record-keeping requirements in order to substantiate our claims for payment under federal, state and commercial health care reimbursement programs. Our records also are subject to routine and other reviews by third-party payors, which can result in delays in payments or refunds of paid claims. For example, we have also experienced a significant increase in pre-payment reviews of our claims by the Durable Medical Equipment Medicare Administrative Contractors, which has caused substantial delays in the collection of our Medicare accounts receivable as well as related amounts due under supplemental insurance plans.

Current law provides for a significant expansion of the government s auditing and oversight of suppliers who care for patients covered by various government health care programs. Examples of this expansion include audit programs being implemented by the Durable Medical Equipment Medicare Administrative Contractors, the Zone Program Integrity Contractors, the Recovery Audit Contractors, and the Comprehensive Error Rate Testing contractors, operating under the direction of the Centers for Medicare & Medicaid Services.

We have been informed by these auditors that health care providers and suppliers of certain durable medical equipment product categories are expected to experience further increased scrutiny from these audit programs. When a government auditor ascribes a high billing error rate to one or more of our locations, it generally results in protracted pre-payment claims review, payment delays, refunds and other payments to the government and/or our need to request more documentation from providers than has historically been required. It may also result in additional audit activity in other company locations in that state or Durable Medical Equipment Medicare Administrative Contractors jurisdiction. We cannot currently predict the adverse impact that these audits, methodologies and interpretations might have on our business, financial condition or operating results, but such impact could be material.

Table of Contents

We are subject to significant regulation by numerous government agencies, including the U.S. Food and Drug Administration, or FDA. We cannot market or commercially distribute our products without obtaining and maintaining necessary regulatory clearances or approvals.

Our Inogen One systems are medical devices subject to extensive regulation in the United States and in the foreign markets where we distribute our products. The FDA and other U.S. and foreign governmental agencies regulate, among other things, with respect to medical devices:

- design, development and manufacturing;
- testing, labeling, content and language of instructions for use and storage;
- clinical trials;
- product safety;
- marketing, sales and distribution;
- pre-market clearance and approval;
- record keeping procedures;
- advertising and promotion;
- recalls and field safety corrective actions;
- post-market surveillance, including reporting of deaths or serious injuries and malfunctions that, if they were to recur, could lead to death or serious injury;
- post-market approval studies; and
- product import and export.

Before we can market or sell a medical device in the United States, we must obtain either clearance from the FDA under Section 510(k) of the Federal Food, Drug, and Cosmetic Act, or the FDCA, or approval of a pre-market approval, application from the FDA, unless an exemption from pre-market review applies. In the 510(k) clearance process, the FDA must determine that a proposed device is substantially equivalent to a device legally on the market, known as a predicate device, with respect to intended use, technology and safety and effectiveness, in order to clear the proposed device for marketing. Clinical data is sometimes required to support substantial equivalence. The pre-market approval pathway requires an applicant to demonstrate the safety and effectiveness of the device based, in part, on extensive data, including, but not limited to, technical, preclinical, clinical trial, manufacturing and labeling data. The pre-market approval process is typically required for devices that are deemed to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices. Products that are approved through a pre-market approval application generally need FDA approval before they can be modified. Similarly, some modifications made to products cleared through a 510(k) may require a new 510(k). Both the 510(k) and pre-market approval processes can be expensive and lengthy and require the payment of

significant fees, unless an exemption applies. The FDA s 510(k) clearance process usually takes from three to 12 months, but may take longer. The process of obtaining a pre-market approval is much more costly and uncertain than the 510(k) clearance process and generally takes from one to three years, or longer, from the time the application is submitted to the FDA until an approval is obtained. The process of obtaining regulatory clearances or approvals to market a medical device can be costly and time consuming, and we may not be able to obtain these clearances or approvals on a timely basis, if at all.

Table of Contents

In the United States, our currently commercialized products are marketed pursuant to pre-market clearance under Section 510(k) of the FDCA. If the FDA requires us to go through a lengthier, more rigorous examination for future products or modifications to existing products than we had expected, our product introductions or modifications could be delayed or canceled, which could cause our sales to decline. In addition, the FDA may determine that future products will require the more costly, lengthy and uncertain pre-market approval process. Although we do not currently market any devices under a pre-market approval, the FDA may demand that we obtain a pre-market approval prior to marketing certain of our future products. In addition, if the FDA disagrees with our determination that a product we currently market is subject to an exemption from pre-market review, the FDA may require us to submit a 510(k) or pre-market approval application in order to continue marketing the product. Further, even with respect to those future products where a pre-market approval is not required, we cannot assure you that we will be able to obtain the 510(k) clearances with respect to those products.

The FDA can delay, limit or deny clearance or approval of a device for many reasons, including:

- we may not be able to demonstrate to the FDA s satisfaction that our products are safe and effective for their intended users;
- the data from our pre-clinical studies and clinical trials may be insufficient to support clearance or approval, where required; and
- the manufacturing process or facilities we use may not meet applicable requirements.

In addition, the FDA may change its clearance and approval policies, adopt additional regulations or revise existing regulations, or take other actions which may prevent or delay approval or clearance of our products under development or impact our ability to modify our currently approved or cleared products on a timely basis. For example, in response to industry and healthcare provider concerns regarding the predictability, consistency and rigor of the 510(k) regulatory pathway, the FDA initiated an evaluation of the program, and in January 2011, announced several proposed actions intended to reform the review process governing the clearance of medical devices. The FDA intends these reform actions to improve the efficiency and transparency of the clearance process, as well as bolster patient safety. Some of these proposals, if enacted, could impose additional regulatory requirements upon us which could delay our ability to obtain new 510(k) clearances, increase the costs of compliance or restrict our ability to maintain our current clearances. In addition, as part of the Food and Drug Administration Safety and Innovation Act, Congress reauthorized the Medical Device User Fee Amendments with various FDA performance goal commitments and enacted several Medical Device Regulatory Improvements and miscellaneous reforms which are further intended to clarify and improve medical device regulation bot pre- and post-market.

Medical devices may only be promoted and sold for the indications for which they are approved or cleared. In addition, even if the FDA has approved or cleared a product, it can take action affecting such product approvals or clearances if serious safety or other problems develop in the marketplace. Delays in obtaining clearances or approvals could adversely affect our ability to introduce new products or modifications to our existing products in a timely manner, which would delay or prevent commercial sales of our products. Additionally, the FDA and other regulatory authorities have broad enforcement powers. Regulatory enforcement or inquiries, or other increased scrutiny on us, could affect the perceived safety and efficacy of our products and dissuade our customers from using our products.

Table of Contents

If we modify our FDA cleared devices, we may need to seek additional clearances or approvals, which, if not granted, would prevent us from selling our modified products.

Our Inogen One systems have received pre-market clearance under Section 510(k) of the FDCA. The modifications made to our Inogen One G2 and Inogen One G3 systems represent non-significant modifications to the original Inogen One system, have the same indications for use, and are covered under our initial Inogen One 510(k) clearance. Any modifications to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or would constitute a major change in its intended use, manufacture, design, components, or technology requires the submission and clearance of a new 510(k) pre-market notification or, possibly, pre-market approval. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer s decision. The FDA may not agree with our decisions regarding whether new clearances or approvals are necessary. We have modified some of our 510(k) cleared products, and have determined based on our review of the applicable FDA guidance that in certain instances new 510(k) clearances or pre-market approval are not required. If the FDA disagrees with our determination and requires us to submit new 510(k) notifications or pre-market approval for modifications to our previously cleared products for which we have concluded that new clearances or approvals are unnecessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties.

Furthermore, the FDA s ongoing review of the 510(k) program may make it more difficult for us to make modifications to our previously cleared products, either by imposing more strict requirements on when a manufacturer must submit a new 510(k) for a modification to a previously cleared product, or by applying more onerous review criteria to such submissions. Specifically, pursuant to the Food and Drug Administration Safety and Innovation Act, which was signed into law in July 2012, the FDA is obligated to prepare a report for Congress on the FDA s approach for determining when a new 510(k) will be required for modifications or changes to a previously cleared device. After submitting this report, the FDA is expected to issue revised guidance to assist device manufacturers in making this determination. Until then, manufacturers may continue to adhere to the FDA s 1997 guidance on this topic when making a determination as to whether or not a new 510(k) is required for a change or modification to a device, but the practical impact of the FDA s continuing scrutiny of these issues remains unclear.

If we fail to comply with FDA or state regulatory requirements, we can be subject to enforcement action.

The regulations to which we are subject are complex and have become more stringent over time. Regulatory changes could result in restrictions on our ability to continue or expand our operations, higher than anticipated costs or lower than anticipated sales. Even after we have obtained the proper regulatory clearance or approval to market a product, we have ongoing responsibilities under FDA regulations. The FDA and state authorities have broad enforcement powers. Our failure to comply with applicable regulatory requirements could result in enforcement action by the FDA or state agencies, which may include any of the following sanctions:

warning letters, fines, injunctions, consent decrees and civil penalties;

recalls, termination of distribution, or seizure of our products;

operating restrictions or partial suspension or total shutdown of production;

Table of Contents

delays in the introduction of products into the market;

refusal to grant our requests for future 510(k) clearances or approvals of new products, new intended uses, or modifications to exiting products;

withdrawals or suspensions of current 510(k) clearances or approvals, resulting in prohibitions on sales of our products; and

criminal prosecution.

Any of these sanctions could result in higher than anticipated costs or lower than anticipated sales and have a material adverse effect on our reputation, business, results of operations and financial condition.

A recall of our products, either voluntarily or at the direction of the FDA or another governmental authority, or the discovery of serious safety issues with our products that leads to corrective actions, could have a significant adverse impact on us.

Medical devices, such as our Inogen One systems, can experience performance problems in the field that require review and possible corrective action by us or the product manufacturer. We cannot provide assurance that component failures, manufacturing errors, design defects and/or labeling inadequacies, which could result in an unsafe condition or injury to the operator or the patient will not occur. The FDA and similar foreign governmental authorities have the authority to require the recall of commercialized products in the event of material deficiencies or defects in design or manufacture of a product or in the event that a product poses an unacceptable risk to health. Manufacturers may also, under their own initiative, recall a product if any material deficiency in a device is found or withdraw a product to improve device performance or for other reasons. A government-mandated or voluntary recall by us or one of our distributors could occur as a result of an unacceptable risk to health, component failures, manufacturing errors, design or labeling defects or other deficiencies and issues. Similar regulatory agencies in other countries have similar authority to recall devices because of material deficiencies or defects in design or manufacture that could endanger health. Any recall would divert management attention and financial resources, could cause the price of our stock to decline and expose us to product liability or other claims and harm our reputation with customers. A recall involving our Inogen One systems could be particularly harmful to our business, financial and operating results.

In addition, under the FDA s medical device reporting regulations, we are required to report to the FDA any incident in which our product may have caused or contributed to a death or serious injury or in which our product malfunctioned and, if the malfunction were to recur, would likely cause or contribute to death or serious injury. Repeated product malfunctions may result in a voluntary or involuntary product recall. Depending on the corrective action we take to redress a product s deficiencies or defects, the FDA may require, or we may decide, that we will need to obtain new approvals or clearances for the device before we may market or distribute the corrected device. Seeking such approvals or clearances may delay our ability to replace the recalled devices in a timely manner. Moreover, if we do not adequately address problems associated with our devices, we may face additional regulatory enforcement action, including FDA warning letters, product seizure, injunctions, administrative penalties, or civil or criminal fines. We may also be required to bear other costs or take other actions that may have a negative impact on our sales as well as face significant adverse publicity or regulatory consequences, which could harm our business, including our ability to market our products in the future.

Table of Contents

Any adverse event involving our products, whether in the United States or abroad, could result in future voluntary corrective actions, such as recalls or customer notifications, or agency action, such as inspection, mandatory recall or other enforcement action. Any corrective action, whether voluntary or involuntary, as well as defending ourselves in a lawsuit, will require the dedication of our time and capital, distract management from operating our business and may harm our reputation and financial results.

If we or our component manufacturers fail to comply with the FDA s Quality System Regulation, our manufacturing operations could be interrupted, and our product sales and operating results could suffer.

We and our component manufacturers are required to comply with the FDA s Quality System Regulation, or QSR, which covers the procedures and documentation of the design, testing, production, control, quality assurance, labeling, packaging, sterilization, storage and shipping of our devices. The FDA audits compliance with the QSR through periodic announced and unannounced inspections of manufacturing and other facilities. We and our component manufacturers have been, and anticipate in the future being, subject to such inspections. Although we believe our manufacturing facilities and those of our component manufacturers are in compliance with the QSR, we cannot provide assurance that any future inspection will not result in adverse findings. If our manufacturing facilities or those of any of our component manufacturers or suppliers are found to be in violation of applicable laws and regulations, or we or our manufacturers or suppliers fail to take satisfactory corrective action in response to an adverse inspection, the FDA could take enforcement action, including any of the following sanctions:

untitled letters, warning letters, fines, injunctions, consent decrees and civil penalties;

customer notifications or repair, replacement, refunds, recall, detention or seizure of our products;

operating restrictions or partial suspension or total shutdown of production;

refusing or delaying our requests for 510(k) clearance or pre-market approval of new products or modified products;

withdrawing 510(k) clearances or pre-market approvals that have already been granted;

refusal to grant export approval for our products; or

criminal prosecution.

Any of these sanctions could adversely affect our business, financial conditions and operating results.

Outside the United States, our products and operations are also often required to comply with standards set by industrial standards bodies, such as the International Organization for Standardization, or ISO. Foreign regulatory bodies may evaluate our products or the testing that our products undergo against these standards. The specific standards, types of evaluation and scope of review differ among foreign regulatory bodies. If we fail to adequately comply with any of these standards, a foreign regulatory body may take adverse actions similar to those within the power of the FDA. Any such action may harm our reputation and could have an adverse effect on our business, results of operations and financial condition.

Table of Contents

If we fail to obtain and maintain regulatory approval in foreign jurisdictions, our market opportunities will be limited.

Approximately 27% of our revenue was from sales outside of the United States in 2012. We sell our products in 41 countries outside of the United States through distributors or directly to large house accounts. In order to market our products in the European Union or other foreign jurisdictions, we must obtain and maintain separate regulatory approvals and comply with numerous and varying regulatory requirements. The approval procedure varies from country to country and can involve additional testing. The time required to obtain approval abroad may be longer than the time required to obtain FDA clearance. The foreign regulatory approval process includes many of the risks associated with obtaining FDA clearance and we may not obtain foreign regulatory approvals on a timely basis, if at all. FDA clearance does not ensure approval by regulatory authorities in other countries, and approval by one foreign regulatory authority does not ensure approval by regulatory authorities in other foreign countries. However, the failure to obtain clearance or approval in one jurisdiction may have a negative impact on our ability to obtain clearance or approval elsewhere. If we do not obtain or maintain necessary approvals to commercialize our products in markets outside the United States, it would negatively affect our overall market penetration.

We may be subject to fines, penalties or injunctions if we are determined to be promoting the use of our products for unapproved or off-label uses, resulting in damage to our reputation and business.

Our promotional materials and training methods must comply with FDA and other applicable laws and regulations, including the prohibition of the promotion of a medical device for a use that has not been cleared or approved by the FDA. Use of a device outside its cleared or approved indications is known as off-label use. Physicians may use our products off-label, as the FDA does not restrict or regulate a physician s choice of treatment within the practice of medicine. If the FDA determines that our promotional materials or training constitutes promotion of an off-label use, it could request that we modify our training or promotional materials or subject us to regulatory or enforcement actions, which could have an adverse impact on our reputation and financial results.

Failure to comply with the Federal Health Insurance Portability and Accountability Act of 1996, or HIPAA, the Health Information Technology for Economic and Clinical Health Act, or HITECH Act, and implementing regulations (including the final omnibus rule published on January 25, 2013) affecting the transmission, security and privacy of health information could result in significant penalties.

Numerous federal and state laws and regulations, including HIPAA and the HITECH Act, govern the collection, dissemination, security, use and confidentiality of patient-identifiable health information. HIPAA and the HITECH Act require us to comply with standards for the use and disclosure of health information within our company and with third parties. The Privacy Standards and Security Standards under HIPAA establish a set of basic national privacy and security standards for the protection of individually identifiable health information by health plans, healthcare clearinghouses and certain healthcare providers, referred to as covered entities, and the business associates with whom such covered entities contract for services. Notably, whereas HIPAA previously directly regulated only these covered entities, the HITECH Act, which was signed into law as part of the stimulus package in February 2009, makes certain of HIPAA s privacy and security standards also directly applicable to covered entities business associates. As a

Table of Contents

result, both covered entities and business associates are now subject to significant civil and criminal penalties for failure to comply with Privacy Standards and Security Standards.

HIPAA and the HITECH Act also include standards for common health care electronic transactions and code sets, such as claims information, plan eligibility, payment information and the use of electronic signatures, and privacy and electronic security of individually identifiable health information. Covered entities, such as health care providers, are required to conform to such transaction set standards pursuant to HIPAA.

HIPAA requires health care providers like us to develop and maintain policies and procedures with respect to protected health information that is used or disclosed, including the adoption of administrative, physical and technical safeguards to protect such information. The HITECH Act expands the notification requirement for breaches of patient-identifiable health information, restricts certain disclosures and sales of patient-identifiable health information and provides a tiered system for civil monetary penalties for HIPAA violations. The HITECH Act also increased the civil and criminal penalties that may be imposed against covered entities, business associates and possibly other persons and gave state attorneys general new authority to file civil actions for damages or injunctions in federal courts to enforce the federal HIPAA laws and seek attorney fees and costs associated with pursuing federal civil actions. Additionally, certain states have adopted comparable privacy and security laws and regulations, some of which may be more stringent than HIPAA.

If we do not comply with existing or new laws and regulations related to patient health information, we could be subject to criminal or civil sanctions. New health information standards, whether implemented pursuant to HIPAA, the HITECH Act, congressional action or otherwise, could have a significant effect on the manner in which we handle health care related data and communicate with payors, and the cost of complying with these standards could be significant.

The 2013 final HITECH omnibus rule modifies the breach reporting standard in a manner that will likely make more data security incidents qualify as reportable breaches. Any liability from a failure to comply with the requirements of HIPAA or the HITECH Act could adversely affect our financial condition. The costs of complying with privacy and security related legal and regulatory requirements are burdensome and could have a material adverse effect on our results of operations. These new provisions, as modified, will be subject to interpretation by various courts and other governmental authorities, thus creating potentially complex compliance issues for us, as well as our clients and strategic partners. In addition, we are unable to predict what changes to the HIPAA Privacy Standards and Security Standards might be made in the future or how those changes could affect our business. Any new legislation or regulation in the area of privacy and security of personal information, including personal health information, could also adversely affect our business operations.

Regulations requiring the use of standard transactions for healthcare services issued under HIPAA may negatively impact our profitability and cash flows.

Pursuant to HIPAA, final regulations have been implemented to improve the efficiency and effectiveness of the healthcare system by facilitating the electronic exchange of information in certain financial and administrative transactions while protecting the privacy and security of the information exchanged.

The HIPAA transaction standards are complex, and subject to differences in interpretation by third-party payors. For instance, some third-party payors may interpret the standards to require

Table of Contents

us to provide certain types of information, including demographic information not usually provided to us by physicians. As a result of inconsistent application of transaction standards by third-party payors or our inability to obtain certain billing information not usually provided to us by physicians, we could face increased costs and complexity, a temporary disruption in accounts receivable and ongoing reductions in reimbursements and net revenue. In addition, requirements for additional standard transactions, such as claims attachments or use of a national provider identifier, could prove technically difficult, time-consuming or expensive to implement, all of which could harm our business.

If we fail to comply with state and federal fraud and above laws, including anti-kickback, false claims and anti-inducement laws, we could face substantial penalties and our business, operations, and financial condition could be adversely affected.

The federal anti-kickback statute prohibits, among other things, knowingly and willfully offering, paying, soliciting or receiving remuneration to induce or in return for purchasing, leasing, ordering, or arranging for the purchase, lease or order of any healthcare item or service reimbursable under Medicare, Medicaid, or other federal financed healthcare programs. Although there are a number of statutory exceptions and regulatory safe harbors protecting certain common activities from prosecution, the exceptions and safe harbors are drawn narrowly, and any remuneration to or from a prescriber or purchaser of healthcare products or services may be subject to scrutiny if they do not qualify for an exception or safe harbor. Our practices may not in all cases meet all of the criteria for safe harbor protection from anti-kickback liability.

Federal false claims laws prohibit any person from knowingly presenting or causing to be presented a false claim for payment to the federal government, or knowingly making or causing to be made a false statement to get a false claim paid. The majority of states also have statutes or regulations similar to the federal anti-kickback law and false claims laws, which apply to items or services reimbursed under Medicaid and other state programs, or, in several states, apply regardless of payor. These false claims statutes allow any person to bring suit in the name of the government alleging false and fraudulent claims presented to or paid by the government (or other violations of the statutes) and to share in any amounts paid by the entity to the government in fines or settlement. Such suits, known as *qui tam* actions, have increased significantly in the healthcare industry in recent years. Sanctions under these federal and state laws may include civil monetary penalties, exclusion of a manufacturer s products from reimbursement under government programs, criminal fines and imprisonment. In addition, the recently enacted Patient Protection and Affordable Care Act, among other things, amends the intent requirement of the federal anti-kickback and criminal healthcare fraud statutes. A person or entity no longer needs to have actual knowledge of this statute or specific intent to violate it. In addition, the Patient Protection and Affordable Care Act provides that the government may assert that a claim including items or services resulting from a violation of the federal anti-kickback statute constitutes a false or fraudulent claim for purposes of the false claims statutes. Because of the breadth of these laws and the narrowness of the safe harbors and exceptions, it is possible that some of our business activities could be subject to challenge under one or more of such laws. Such a challenge, regardless of the outcome, could have a material adverse effect on our business, business relationships, reputation, financial condition and results of operations.

The Patient Protection and Affordable Care Act also imposes new reporting and disclosure requirements on device and drug manufacturers for any transfer of value made or distributed to prescribers and other healthcare providers. Device and drug manufacturers will also be required to report and disclose any investment interests held by physicians and their immediate

Table of Contents

family members during the preceding calendar year. Failure to submit required information may result in civil monetary penalties of up to an aggregate of $150,000 per year (and up to an aggregate of $1 million per year for knowing failures), for all payments, transfers of value or ownership or investment interests not reported in an annual submission. As of August 1, 2013, manufacturers are required to collect data, and they will be required to submit their first data reports to the Centers for Medicare & Medicaid Services by March 31, 2014 and by the 90th day of each calendar year thereafter.

In addition, there has been a recent trend of increased federal and state regulation of payments made to physicians. Certain states, mandate implementation of compliance programs and/or the tracking and reporting of gifts, compensation and other remuneration to physicians. The shifting compliance environment and the need to build and maintain robust and expandable systems to comply with different compliance and/or reporting requirements in multiple jurisdictions increase the possibility that a healthcare company many violate one or more of the requirements.

The Federal Civil Monetary Penalties Law prohibits the offering or giving of remuneration to a Medicare or Medicaid beneficiary that the person knows or should know is likely to influence the beneficiary s selection of a particular supplier of items or services reimbursable by a Federal or state governmental program. We sometimes offer customers various discounts and other financial incentives in connection with the sales of our products. While it is our intent to comply with all applicable laws, the government may find that our marketing activities violate the Civil Monetary Penalties Law. If we are found to be in noncompliance, we could be subject to civil money penalties of up to $10,000 for each wrongful act, assessment of three times the amount claimed for each item or service and exclusion from the Federal healthcare programs.

The scope and enforcement of each of these laws is uncertain and subject to rapid change in the current environment of healthcare reform, especially in light of the lack of applicable precedent and regulations. If our operations are found to be in violation of any of the laws described above or any other government regulations that apply to us, we may be subject to penalties, including civil and criminal penalties, damages, fines and the curtailment or restricting of our operations. Any penalties, damages, fines, curtailment or restructuring or our operations could harm our ability to operate our business and our financial results. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management s attention from operation of our business. Moreover, achieving and sustaining compliance with applicable federal and state fraud laws may prove costly.

Foreign governments tend to impose strict price controls, which may adversely affect our future profitability.

We sell our products in 41 countries outside the United States through distributors or directly to large house accounts. In some foreign countries, particularly in the European Union, the pricing of medical devices is subject to governmental control. In these countries, pricing negotiations with governmental authorities can take considerable time after the receipt of marketing approval for a product. To obtain reimbursement or pricing approval in some countries, we may be required to supply data that compares the cost-effectiveness of our Inogen One systems to other available oxygen therapies. If reimbursement of our products is unavailable or limited in scope or amount, or if pricing is set at unsatisfactory levels, it may not be profitable to sell our products in certain foreign countries, which would negatively affect the long-term growth of our business.

Table of Contents

Our business activities involve the use of hazardous materials, which require compliance with environmental and occupational safety laws regulating the use of such materials. If we violate these laws, we could be subject to significant fines, liabilities or other adverse consequences.

Our research and development programs as well as our manufacturing operations involve the controlled use of hazardous materials. Accordingly, we are subject to federal, state and local laws governing the use, handling and disposal of these materials. Although we believe that our safety procedures for handling and disposing of these materials comply in all material respects with the standards prescribed by state and federal regulations, we cannot completely eliminate the risk of accidental contamination or injury from these materials. In the event of an accident or failure to comply with environmental laws, we could be held liable for resulting damages, and any such liability could exceed our insurance coverage.

Risks related to our intellectual property

If we are unable to secure and maintain patent or other intellectual property protection for the intellectual property used in our products, we will lose a significant competitive advantage.

Our commercial success depends, in part, on obtaining and maintaining patent and other intellectual property protection for the technologies used in our products. The patent positions of medical device companies, including ours, can be highly uncertain and involve complex and evolving legal and factual questions. Furthermore, we might in the future opt to license intellectual property from other parties. If we, or the other parties from whom we would license intellectual property, fail to obtain and maintain adequate patent or other intellectual property protection for intellectual property used in our products, or if any protection is reduced or eliminated, others could use the intellectual property used in our products, resulting in harm to our competitive business position. In addition, patent and other intellectual property protection may not:

- prevent our competitors from duplicating our products;
- prevent our competitors from gaining access to our proprietary information and technology; or
- permit us to gain or maintain a competitive advantage.

Any of our patents may be challenged, invalidated, circumvented or rendered unenforceable. We cannot provide assurance that we will be successful should one or more of our patents be challenged for any reason. If our patent claims are rendered invalid or unenforceable, or narrowed in scope, the patent coverage afforded our products could be impaired, which could make our products less competitive.

As of January 1, 2014, we had six pending U.S. patent applications, 24 issued U.S. patents and one issued Canadian patent relating to the design and construction of our oxygen concentrators and our intelligent delivery technology. We cannot specify which of these patents individually or as a group will permit us to gain or maintain a competitive advantage. U.S. patents and patent applications may be subject to interference proceedings, and U.S. patents may be subject to re-examination *inter partes* review, post-grant review, and derivation proceedings in the U.S. Patent and Trademark Office. Foreign patents may be subject to opposition or comparable proceedings in the corresponding foreign patent offices. Any of these proceedings could result in loss of the patent or denial of the patent application, or loss or reduction in the scope of one or more of the claims of the patent or patent application. Changes in either patent laws or in interpretations of patent laws may also diminish the value of our intellectual property or narrow the scope of our

Table of Contents

protection. Interference, re-examination and opposition proceedings may be costly and time consuming, and we, or the other parties from whom we might potentially license intellectual property, may be unsuccessful in defending against such proceedings. Thus, any patents that we own or might license may provide limited or no protection against competitors. In addition, our pending patent applications and those we may file in the future may have claims narrowed during prosecution or may not result in patents being issued. Even if any of our pending or future applications are issued, they may not provide us with adequate protection or any competitive advantages. Our patents and patent applications cover particular aspects of our products. Other parties may develop and obtain patent protection for more effective technologies, designs or methods for oxygen therapy. If these developments were to occur, it would likely have an adverse effect on our sales. Our ability to develop additional patentable technology is also uncertain.

Non-payment or delay in payment of patent fees or annuities, whether intentional or unintentional, may also result in the loss of patents or patent rights important to our business. Many countries, including certain countries in Europe, have compulsory licensing laws under which a patent owner may be compelled to grant licenses to other parties. In addition, many countries limit the enforceability of patents against other parties, including government agencies or government contractors. In these countries, the patent owner may have limited remedies, which could materially diminish the value of the patent. In addition, the laws of some foreign countries do not protect intellectual property rights to the same extent as do the laws of the United States, particularly in the field of medical products and procedures

Our products could infringe the intellectual property rights of others, which may lead to patent and other intellectual property litigation that could itself be costly, could result in the payment of substantial damages or royalties, prevent us from using technology that is essential to our products, and/or force us to discontinue selling our products.

The medical device industry in general has been characterized by extensive litigation and administrative proceedings regarding patent infringement and intellectual property rights. Our competitors hold a significant number of patents relating to oxygen therapy devices and products. From time to time, we have commenced litigation to enforce our intellectual property rights. For example, we have pursued litigation against Inova Labs for infringement of two of our patents seeking damages, injunctive relief, costs, and attorneys fees. An adverse decision in this action or in any other legal action could limit our ability to assert our intellectual property rights, limit the value of our technology or otherwise negatively impact our business, financial condition and results of operations.

Monitoring unauthorized use of our intellectual property is difficult and costly. Unauthorized use of our intellectual property may have occurred or may occur in the future. Although we have taken steps to minimize the risk of this occurring, any such failure to identify unauthorized use and otherwise adequately protect our intellectual property would adversely affect our business. Moreover, if we are required to commence litigation, whether as a plaintiff or defendant as has occurred with Inova Labs, not only will this be time-consuming, but we will also be forced to incur significant costs and divert our attention and efforts of our employees, which could, in turn, result in lower revenue and higher expenses.

We cannot provide assurance that our products or methods do not infringe the patents or other intellectual property rights of third parties and if our business is successful, the possibility may increase that others will assert infringement claims against us.

Table of Contents

Determining whether a product infringes a patent involves complex legal and factual issues, and the outcome of a patent litigation action is often uncertain. We have not conducted an extensive search of patents issued or assigned to other parties, including our competitors, and no assurance can be given that patents containing claims covering our products, parts of our products, technology or methods do not exist, have not been filed or could not be filed or issued. Because of the number of patents issued and patent applications filed in our technical areas, our competitors or other parties may assert that our products and the methods we employ in the use of our products are covered by U.S. or foreign patents held by them. In addition, because patent applications can take many years to issue and because publication schedules for pending applications vary by jurisdiction and some companies opt not to publish their patent applications, there may be applications now pending of which we are unaware and which may result in issued patents that our current or future products infringe. Also, because the claims of published patent applications can change between publication and patent grant, there may be published patent applications that may ultimately issue with claims that we infringe. There could also be existing patents that one or more of our products or parts may infringe and of which we are unaware. As the number of competitors in the market for oxygen products and as the number of patents issued in this area grows, the possibility of patent infringement claims against us increases. In certain situations, we may determine that it is in our best interests to voluntarily challenge a party s products or patents in litigation or other proceedings, including patent interferences or re-examinations. As a result, we may become involved in unwanted litigation that could be costly, result in diversion of management s attention, require us to pay damages and force us to discontinue selling our products.

Infringement and other intellectual property claims and proceedings brought against us, whether successful or not, could result in substantial costs and harm to our reputation. Such claims and proceedings can also distract and divert management and key personnel from other tasks important to the success of the business. We cannot be certain that we will successfully defend against allegations of infringement of patents and intellectual property rights of others. In the event that we become subject to a patent infringement or other intellectual property lawsuit and if the other party s patents or other intellectual property were upheld as valid and enforceable and we were found to infringe the other party s patents or violate the terms of a license to which we are a party, we could be required to do one or more of the following:

- cease selling or using any of our products that incorporate the asserted intellectual property, which would adversely affect our revenue;
- pay damages for past use of the asserted intellectual property, which may be substantial;
- obtain a license from the holder of the asserted intellectual property, which license may not be available on reasonable terms, if at all, and which could reduce profitability; and
- redesign or rename, in the case of trademark claims, our products to avoid infringing the intellectual property rights of third parties, which may not be possible and could be costly and time-consuming if it is possible to do so.

If we are unable to prevent unauthorized use or disclosure of trade secrets, unpatented know-how and other proprietary information, our ability to compete will be harmed.

We rely on a combination of trade secrets, copyrights, trademarks, confidentiality agreements and other contractual provisions and technical security measures to protect certain aspects of our technology, especially where we do not believe that patent protection is appropriate or

Table of Contents

obtainable. We require our employees and consultants to execute confidentiality agreements in connection with their employment or consulting relationships with us. We also require our employees and consultants to disclose and assign to us all inventions conceived during the term of their employment or engagement while using our property or that relate to our business. We also require our corporate partners, outside scientific collaborators and sponsored researchers, advisors and others with access to our confidential information to sign confidentiality agreements. We also have taken precautions to initiate reasonable safeguards to protect our information technology systems. However, these measures may not be adequate to safeguard our proprietary intellectual property and conflicts may, nonetheless, arise regarding ownership of inventions. Such conflicts may lead to the loss or impairment of our intellectual property or to expensive litigation to defend our rights against competitors who may be better funded and have superior resources. Our employees, consultants, contractors, outside clinical collaborators and other advisors may unintentionally or willfully disclose our confidential information to competitors. In addition, confidentiality agreements may be unenforceable or may not provide an adequate remedy in the event of unauthorized disclosure. Enforcing a claim that a third party illegally obtained and is using our trade secrets is expensive and time-consuming, and the outcome is unpredictable. Moreover, our competitors may independently develop equivalent knowledge, methods and know-how. Unauthorized parties may also attempt to copy or reverse engineer certain aspects of our products that we consider proprietary, and in such cases we could not assert any trade secret rights against such party. As a result, other parties may be able to use our proprietary technology or information, and our ability to compete in the market would be harmed.

We may be subject to damages resulting from claims that our employees or we have wrongfully used or disclosed alleged trade secrets of other companies.

Many of our employees were previously employed at other medical device companies focused on the development of oxygen therapy products, including our competitors. Although no claims against us are currently pending, we may be subject to claims that these employees or we have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. If we fail in defending such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights. Even if we are successful in defending against these claims, litigation could result in substantial costs, damage to our reputation and be a distraction to management.

Risks related to being a public company

We will incur increased costs as a result of operating as a public company and our management will be required to devote substantial time to new compliance initiatives and corporate governance practices.

As a public company, and increasingly after we are no longer an emerging growth company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act and rules subsequently implemented by the SEC and the NASDAQ Global Market impose numerous requirements on public companies, including establishment and maintenance of effective disclosure and financial controls and corporate governance practices. Also, the Securities Exchange Act of 1934, as amended, or the Exchange Act, requires, among other things, that we file annual, quarterly and current reports with respect to our business and operating results. Our management and other personnel will need to devote a substantial amount of time to compliance with these laws and regulations. These requirements

Table of Contents

have increased and will continue to increase our legal, accounting, and financial compliance costs and have made and will continue to make some activities more time consuming and costly. For example, we expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to incur substantial costs to maintain the same or similar coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors or our board committees or as executive officers.

Overall, we estimate that our incremental costs resulting from operating as a public company, including compliance with these rules and regulations, may be between $1.5 million and $3.0 million per year. However, these rules and regulations are often subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices.

The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually and the effectiveness of our disclosure controls and procedures quarterly. In particular, Section 404(a) of the Sarbanes-Oxley Act, or Section 404(a), will require us to perform system and process evaluation and testing of our internal control over financial reporting to allow management to report on the effectiveness of our internal control over financial reporting. Section 404(b) of Sarbanes-Oxley Act also requires our independent registered public accounting firm to attest to the effectiveness of our internal control over financial reporting. As an emerging growth company we expect to avail ourselves of the exemption from the requirement that our independent registered public accounting firm attest to the effectiveness of our internal control over financial reporting under Section 404(b). However, we may no longer avail ourselves of this exemption when we are no longer an emerging growth company. When our independent registered public accounting firm is required to undertake an assessment of our internal control over financial reporting, the cost of our compliance with Section 404(b) will correspondingly increase. Our compliance with applicable provisions of Section 404 will require that we incur substantial accounting expense and expend significant management time on compliance-related issues as we implement additional corporate governance practices and comply with reporting requirements.

Furthermore, investor perceptions of our company may suffer if deficiencies are found, and this could cause a decline in the market price of our stock. Irrespective of compliance with Section 404, any failure of our internal control over financial reporting could have a material adverse effect on our stated operating results and harm our reputation. If we are unable to implement these requirements effectively or efficiently, it could harm our operations, financial reporting, or financial results and could result in an adverse opinion on our internal controls from our independent registered public accounting firm.

We have identified material weaknesses in our internal control over financial reporting. If we do not remediate the material weaknesses in our internal control over financial reporting, we may not be able to accurately report our financial results or file our periodic reports in a timely manner, which may cause investors to lose confidence in our reported financial information and may lead to a decline in the market price of our stock.

Effective internal control over financial reporting is necessary for us to provide reliable financial reports in a timely manner. In connection with the audits of our financial statements for the

Table of Contents

years ended December 31, 2011 and 2012, we concluded that there were material weaknesses in our internal control over financial reporting. A material weakness is a significant deficiency, or a combination of significant deficiencies, in internal control over financial reporting such that it is reasonably possible that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. The material weaknesses that we identified related to (1) a lack of sufficient staff to deal with the various rules and regulations with respect to financial reporting, (2) accounting for revenue recognition as it relates to properly recording deferred revenue, estimated earned but unbilled revenue and billing adjustments and (3) accounting for warranty revenue and cost recognition with regard to lifetime warranties.

In an attempt to remediate our staff resource weakness, we have taken steps to hire additional finance and accounting personnel to augment our accounting staff and to provide more resources for complex GAAP accounting matters. In an attempt to remediate our revenue recognition weakness, we intend to review our revenue recognition policies and procedures, enhance training of our personnel with respect to such policies and procedures and devote additional resources to our revenue recognition, including adding additional accounting staff with technical experience in revenue recognition arrangements. However, we cannot assure you that these efforts will remediate our material weaknesses in a timely manner, or at all, or prevent restatements of our financial statements in the future. If we are unable to successfully remediate our material weaknesses, or identify any future significant deficiencies or material weaknesses, the accuracy and timing of our financial reporting may be adversely affected, we may be unable to maintain compliance with securities law requirements regarding timely filing of periodic reports, and the market price of our stock may decline as a result.

Our management and independent registered public accounting firm did not perform an evaluation of our internal control over financial reporting during any period in accordance with the provisions of the Sarbanes-Oxley Act. Had we and our independent registered public accounting firm performed an evaluation of our internal control over financial reporting in accordance with the provisions of the Sarbanes-Oxley Act, additional control deficiencies amounting to material weaknesses may have been identified. We cannot be certain as to when we will be able to implement the requirements of Section 404 of the Sarbanes-Oxley Act. If we fail to implement the requirements of Section 404 in a timely manner, we might be subject to sanctions or investigation by regulatory agencies such as the SEC. In addition, failure to comply with Section 404 or the report by us of a material weakness may cause investors to lose confidence in our financial statements, and the trading price of our common stock may decline. If we fail to remedy any material weakness, our financial statements may be inaccurate, our access to the capital markets may be restricted and the trading price of our ordinary shares may suffer.

We are an emerging growth company, and the reduced disclosure requirements applicable to emerging growth companies could make our common stock less attractive to investors.

We are an emerging growth company, as defined in the Jumpstart Our Business Startups, or JOBS, Act enacted in April 2012, and may remain an emerging growth company for up to five years following the completion of this offering, although, if we have more than $1.0 billion in annual revenue, if the market value of our common stock that is held by non-affiliates exceeds $700 million as of June 30 of any year, or we issue more than $1.0 billion of non-convertible debt over a three-year period before the end of that five-year period, we would cease to be an emerging growth company as of the following December 31. For as long as we remain an emerging growth company, we are permitted and intend to rely on exemptions from certain

Table of Contents

disclosure requirements that are applicable to other public companies that are not emerging growth companies. These exemptions include:

- being permitted to provide only two years of audited financial statements, in addition to any required unaudited interim financial statements, with correspondingly reduced Management s discussion and analysis of financial condition and results of operations disclosure;
- not being required to comply with the auditor attestation requirements in the assessment of our internal control over financial reporting;
- not being required to comply with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor s report providing additional information about the audit and the financial statements;
- reduced disclosure obligations regarding executive compensation; and
- exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved.

We have taken advantage of reduced reporting burdens in this prospectus. In particular, in this prospectus, we have provided only two years of audited financial statements and have not included all of the executive compensation related information that would be required if we were not an emerging growth company. In addition, the JOBS Act provides that an emerging growth company can take advantage of an extended transition period for complying with new or revised accounting standards, delaying the adoption of these accounting standards until they would apply to private companies. We have elected to avail ourselves of this exemption and, as a result, our financial statements may not be comparable to the financial statements of issuers who are required to comply with the effective dates for new or revised accounting standards that are applicable to public companies. We cannot predict whether investors will find our common stock less attractive if we rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be reduced or more volatile.

Risks related to our common stock and this offering

We expect that our stock price will fluctuate significantly, and you may not be able to resell your shares at or above the initial public offering price.

Prior to this offering, there has been no public market for shares of our common stock. We cannot predict the extent to which investor interest in our company will lead to the development of an active trading market on the NASDAQ Global Market or otherwise or how liquid that market might become. If an active trading market does not develop, you may have difficulty selling any of our shares of common stock that you buy. We and the underwriters will determine the initial public offering price of our common stock through negotiation. This price will not necessarily reflect the price at which investors in the market will be willing to buy and sell our shares following this offering. In addition, the trading price of our common stock following this offering may be highly volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control. These factors include:

- actual or anticipated quarterly variation in our results of operations or the results of our competitors;

Table of Contents

announcements by us or our competitors of new commercial products, significant contracts, commercial relationships or capital commitments;

issuance of new or changed securities analysts reports or recommendations for our stock;

developments or disputes concerning our intellectual property or other proprietary rights;

commencement of, or our involvement in, litigation;

market conditions in the oxygen therapy market;

reimbursement or legislative changes in the oxygen therapy market;

failure to complete significant sales;

manufacturing disruptions that could occur if we were unable to successfully expand our production in our current or an alternative facility;

any future sales of our common stock or other securities;

any major change to the composition of our board of directors or management; and

general economic conditions and slow or negative growth of our markets.

The stock market in general, and market prices for the securities of technology-based companies like ours in particular, have from time to time experienced volatility that often has been unrelated to the operating performance of the underlying companies. A certain degree of stock price volatility can be attributed to being a newly public company. These broad market and industry fluctuations may adversely affect the market price of our common stock, regardless of our operating performance. In several recent situations where the market price of a stock has been volatile, holders of that stock have instituted securities class action litigation against the company that issued the stock. If any of our stockholders were to bring a lawsuit against us, the defense and disposition of the lawsuit could be costly and divert the time and attention of our management and harm our operating results.

If securities or industry analysts do not publish research or publish unfavorable research about our business, our stock price and trading volume could decline.

The trading market for our common stock will rely in part on the research and reports that equity research analysts publish about us and our business. We do not currently have and may never obtain research coverage by equity research analysts. Equity research analysts may elect not to provide research coverage of our common stock after the completion of this offering, and such lack of research coverage may adversely affect the market price of our common stock. In the event we obtain equity research analyst coverage, we will not have any control of the analysts or the content and opinions included in their reports. The price of our stock could decline if one or more equity research analysts downgrade our stock or issue other unfavorable commentary or research. If one or more equity research analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which in turn could cause our stock price or trading volume to decline.

Purchasers in this offering will experience immediate and substantial dilution in the book value of their investment.

The initial public offering price of our common stock is substantially higher than the net tangible book value per share of our common stock immediately prior to this offering. Therefore, if you

Table of Contents

purchase our common stock in this offering, you will incur an immediate dilution of $12.17 in pro forma as adjusted net tangible book value per share as of September 30, 2013 from the price you paid, based on an assumed initial public offering price of $17.00 per share, the midpoint of the range set forth on the cover page of this prospectus. In addition, new investors who purchase shares in this offering will contribute approximately 40% of the total amount of equity capital raised by us through the date of this offering, but will only own approximately 20% of the outstanding share capital and approximately 20% of the voting rights. In addition, we have issued options and warrants to acquire common stock at prices below the initial public offering price. To the extent outstanding options and warrants are ultimately exercised, there will be further dilution to investors who purchase shares in this offering. In addition, if we issue additional equity securities, investors purchasing shares in this offering will experience additional dilution.

Future sales of shares of our common stock by existing stockholders could cause our stock price to decline.

Based on shares outstanding as of September 30, 2013, upon completion of this offering, we will have outstanding a total of 18,048,936 shares of common stock. Of these shares, only the 4,411,763 shares of common stock sold in this offering by us and the selling stockholders, or 5,073,527 shares if the underwriters exercise their option to purchase additional shares in full, will be freely tradable, without restriction, in the public market immediately after the offering. Each of our directors and officers, and certain of our stockholders, have entered into lock-up agreements with the underwriters that restrict their ability to sell or transfer their shares. The lock-up agreements pertaining to this offering will expire 180 days from the date of this prospectus. Our underwriters, however, may, in their sole discretion, permit our officers, directors and other current stockholders who are subject to the contractual lock-up to sell shares prior to the expiration of the lock-up agreements. After the lock-up agreements expire, based on shares outstanding as of September 30, 2013, up to an additional 14,519,525 shares of common stock will be eligible for sale in the public market, approximately 8,500,000 of which are held by our executive officers, directors and their affiliated entities, and will be subject to volume limitations under Rule 144 under the Securities Act and various vesting agreements. In addition, 2,079,338 shares of our common stock that are subject to outstanding options as of September 30, 2013 will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act. We cannot predict what effect, if any, sales of our shares in the public market or the availability of shares for sale will have on the market price of our common stock. Future sales of substantial amounts of our common stock in the public market, including shares issued upon exercise of outstanding options, or the perception that such sales may occur, however, could adversely affect the market price of our common stock and also could adversely affect our future ability to raise capital through the sale of our common stock or other equity-related securities of ours at times and prices we believe appropriate.

Our directors, executive officers and principal stockholders will continue to have substantial control over us after this offering and could limit your ability to influence the outcome of key transactions, including changes of control.

Following the completion of this offering, our executive officers, directors and stockholders who owned more than 5% of our outstanding common stock before this offering and their respective affiliates will beneficially own or control approximately 71% of the outstanding shares of our common stock, assuming exercise of the underwriters option to purchase additional shares.

Table of Contents

Accordingly, these executive officers, directors and stockholders who owned more than 5% of our outstanding common stock before this offering and their respective affiliates, acting as a group, will have substantial influence over the outcome of corporate actions requiring stockholder approval, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets or any other significant corporate transactions. These stockholders may also delay or prevent a change of control of us, even if such a change of control would benefit our other stockholders. The significant concentration of stock ownership may adversely affect the trading price of our common stock due to investors perception that conflicts of interest may exist or arise.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management and limit the market price of our common stock.

Provisions in our certificate of incorporation and bylaws, as amended and restated upon the closing of this offering, may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws to become effective upon completion of this offering include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our board of directors, the Chairman of the board of directors, or the Chief Executive Officer;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered three year terms;
- provide that our directors may be removed only for cause;
- provide that vacancies on our board of directors may be filled only by a majority of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

These provisions may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which limits the ability of stockholders owning in excess of 15% of our outstanding voting stock to merge or combine with us.

Table of Contents

We have broad discretion in the use of the net proceeds from this offering and may not use them effectively.

We will have broad discretion in the application of the net proceeds from this offering and could spend the proceeds in ways that do not improve our results of operations or enhance the value of our common stock. We intend to use approximately $15 million of the net proceeds from this offering for investments in rental assets; approximately $5 million of the net proceeds for sales and marketing activities, including expansion of our sales force to support the ongoing commercialization of our products; approximately $3 million of the net proceeds for research and product development activities; approximately $11 million of the net proceeds for facilities improvements or expansions and the purchase of manufacturing and other equipment; and the remainder of the net proceeds for working capital and other general corporate purposes. We may also use a portion of our net proceeds to acquire and invest in complementary products, technologies or businesses; however, we currently have no agreements or commitments to complete any such transaction. We have not allocated these net proceeds for any specific purposes. We might not be able to yield a significant return, if any, on any investment of these net proceeds. You will not have the opportunity to influence our management s decisions on how to use the net proceeds from this offering, and our failure to apply these funds effectively could have a material adverse effect on our business and cause the price of our common stock to decline.

We have never paid dividends on our capital stock, and we do not anticipate paying any cash dividends in the foreseeable future.

We have paid no cash dividends on any of our classes of capital stock to date, have contractual restrictions against paying cash dividends and currently intend to retain our future earnings to fund the development and growth of our business. As a result, capital appreciation, if any, of our common stock will be your sole source of gain for the foreseeable future.

Table of Contents

Special note regarding forward-looking statements

This prospectus contains forward-looking statements that are based on management s beliefs and assumptions and on information currently available to management. Some of the statements under Prospectus summary, Risk factors, Management s discussion and analysis of financial condition and results of operations and Business and elsewhere in this prospectus contain forward-looking statements. In some cases, you can identify forward-looking statements by the following words: may, will, could, would, should, expect, intend, plan, anticipate, b predict, project, potential, continue, ongoing or the negative of these terms or other comparable terminology, although not all forward-lookin statements contain these words.

These statements involve risks, uncertainties and other factors that may cause actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. Although we believe that we have a reasonable basis for each forward-looking statement contained in this prospectus, we caution you that these statements are based on a combination of facts and factors currently known by us and our projections of the future, about which we cannot be certain.

In addition, you should refer to the Risk factors section of this prospectus for a discussion of other important factors that may cause actual results to differ materially from those expressed or implied by the forward-looking statements. As a result of these factors, we cannot assure you that the forward-looking statements in this prospectus will prove to be accurate. Furthermore, if the forward-looking statements prove to be inaccurate, the inaccuracy may be material. In light of the significant uncertainties in these forward-looking statements, you should not regard these statements as a representation or warranty by us or any other person that we will achieve our objectives and plans in any specified time frame, or at all. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. The Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act of 1933 do not protect any forward-looking statements that we make in connection with this offering.

This prospectus contains market data and industry forecasts that were obtained from industry publications. These data involve a number of assumptions and limitations, and you are cautioned not to give undue weight to such estimates. We have not independently verified any third-party information. While we believe the market position, market opportunity and market size information included in this prospectus is generally reliable, such information is inherently imprecise.

Table of Contents

Use of proceeds

We estimate that the net proceeds to us from the sale of the shares of common stock in this offering will be approximately $53.4 million, based upon an assumed initial price to the public of $17.00 per share, the mid-point of the range reflected on the cover page of this prospectus, and after deducting estimated underwriting discounts and commissions and estimated offering expenses. We will not receive any proceeds from the sale of common stock by the selling stockholders. Each $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) the net proceeds to us from this offering by approximately $3.28 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same. We may also increase or decrease the number of shares we are offering. Each increase (decrease) of 1,000,000 shares in the number of shares offered by us would increase (decrease) the net proceeds to us from this offering by approximately $15.81 million, assuming that the assumed initial public offering price remains the same, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The principal purposes of this offering are to create a public market for our common stock, obtain additional capital, facilitate our future access to the public equity markets, increase awareness of our company among potential customers and improve our competitive position. We intend to use approximately $15 million of the net proceeds from this offering for investments in rental assets; approximately $5 million of the net proceeds for sales and marketing activities, including expansion of our sales force to support the ongoing commercialization of our products; approximately $3 million of the net proceeds for research and product development activities; approximately $11 million of the net proceeds for facilities improvements or expansions and the purchase of manufacturing and other equipment; and the remainder of the net proceeds for working capital and other general corporate purposes. We may also use a portion of our net proceeds to acquire and invest in complementary products, technologies or businesses; however, we currently have no agreements or commitments to complete any such transaction. The amount and timing of these expenditures will vary depending on a number of factors, including competitive and technological developments and the rate of growth, if any, of our business. Accordingly, we will have broad discretion in using these proceeds.

Pending their use, we plan to invest our net proceeds from this offering in short-term, interest-bearing obligations, investment-grade instruments, certificates of deposit or direct or guaranteed obligations of the U.S. government. Our management will have broad discretion in the application of the net proceeds from this offering to us, and investors will be relying on the judgment of our management regarding the application of the proceeds.

Table of Contents

Dividend policy

We have never declared or paid any cash dividends on our common stock or any other securities. We anticipate that we will retain all available funds and any future earnings, if any, for use in the operation of our business and do not anticipate paying cash dividends in the foreseeable future. In addition, our revolving credit and term loan agreement materially restricts, and future debt instruments we issue may materially restrict, our ability to pay dividends on our common stock. Payment of future cash dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs, the requirements of current or then-existing debt instruments and other factors our board of directors deems relevant.

Table of Contents

Capitalization

The following table summarizes our capitalization as of September 30, 2013:

- on an actual basis;
- on a pro forma basis, to reflect (i) the conversion of all outstanding shares of convertible preferred stock into an aggregate of 14,218,319 shares of common stock upon the closing of this offering, (ii) the cash exercise of warrants to purchase an aggregate of 24,588 shares of common stock, which we expect will occur prior to this offering as the warrants will otherwise expire at that time, (iii) the reclassification of our preferred stock warrant liability to additional-paid-in-capital upon the closing of this offering and (iv) the filing of our amended and restated certificate of incorporation; and
- on a pro forma as adjusted basis, to further reflect the sale and issuance by us of 3,529,411 shares of common stock in this offering at an assumed initial public offering price of $17.00 per share, the midpoint of the range reflected on the cover page of this prospectus, after deducting estimated underwriting discounts and commissions and estimated offering expenses.

You should read the information in this table together with the financial statements and related notes to those statements, as well as the sections of this prospectus captioned Selected financial data and Management s discussion and analysis of financial condition and results of operations.

	As of September 30, 2013		
		Pro forma	
	Actual	Pro forma	as adjusted(1)
	(in thousands, except per share and share amounts)		
Long-term debt, net of current portion	$ 6,648	$ 6,648	$ 6,648
Redeemable convertible preferred stock, $0.001 par value per share; issuable in series, 9,606,450 authorized, 9,541,259 shares issued and outstanding, actual, and no shares issued and outstanding, pro forma; and no shares authorized, issued or outstanding, pro forma as adjusted	116,744		
Stockholders equity (deficit):			
Preferred stock, $0.001 par value per share; 66,666 shares authorized, 66,666 shares issued and outstanding, actual; 10,000,000 authorized, no shares issued or outstanding, pro forma and pro forma as adjusted	247		
Common stock, $0.001 par value per share, 18,333,333 shares authorized, 276,618 shares issued and outstanding, actual; 200,000,000 shares authorized, 14,519,524 shares issued and outstanding, pro forma and 18,048,936 shares issued and outstanding pro forma as adjusted	1	15	19
Additional paid-in capital		117,255	170,681
Accumulated deficit	(82,797)	(82,797)	(82,797)
Total stockholders (deficit) equity	(82,549)	34,473	87,903
Total capitalization	$ 40,843	$ 41,121	$ 94,551

Table of Contents

(1) Each $1.00 increase (decrease) in the assumed initial price to the public of $17.00 per share, the midpoint of the range reflected on the cover page of this prospectus, would increase (decrease) each of additional paid-in capital, total stockholders equity and total capitalization by approximately $3.28 million, assuming that the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same, and after deducting estimated underwriting discounts and commissions and estimated offering expenses. We may also increase or decrease the number of shares we are offering. Each increase (decrease) of 1,000,000 shares in the number of shares offered by us would increase (decrease) each of additional paid-in capital, total stockholders equity and total capitalization by approximately $15.81 million, assuming that the assumed initial price to the public remains the same, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses. The pro forma as adjusted information discussed above is illustrative only and will adjust based on the actual initial price to the public and other terms of this offering determined at pricing.

The outstanding share information in the table above excludes as of September 30, 2013:

2,079,338 shares of common stock issuable upon exercise of options outstanding, 1,466,789 of which were vested and then exercisable, at a weighted average exercise price of $1.0876 per share;

276,334 shares of common stock issuable upon the exercise of options to purchase common stock granted after September 30, 2013, at a weighted average exercise price of $8.37 per share;

1,074,415 shares of common stock reserved for future grants under our stock-based compensation plans as of the date of this prospectus, consisting of:

895,346 shares of common stock reserved for future grants under our 2014 Equity Incentive Plan, which will become effective immediately prior to the date of this prospectus, and any shares subject to stock options under our 2012 Equity Incentive Plan or our 2002 Amended Stock Incentive Plan that expire or otherwise terminate without having been exercised in full and any shares issued pursuant to awards granted under such plans that are forfeited to or repurchased by us, with the maximum number of shares to be added to the 2014 Equity Incentive Plan equal to 2,328,569 shares;

179,069 shares of common stock reserved for future issuance under our 2014 Employee Stock Purchase Plan, which will become effective immediately prior to the date of this prospectus; and

Any shares of common stock that become available subsequent to this offering under our 2014 Equity Incentive Plan and 2014 Employee Stock Purchase Plan pursuant to the provisions thereof that automatically increase the shares reserved for issuance under such plans each year, as more fully described in Executive compensation Employee benefit and stock plans; and

268,200 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2013, at a weighted average exercise price of $1.4216 per share, after conversion of the convertible preferred stock.

Table of Contents

Dilution

If you invest in our common stock in this offering you will experience immediate and substantial dilution in the pro forma as adjusted net tangible book value of your shares of common stock. Dilution in pro forma as adjusted net tangible book value represents the difference between the assumed initial price to the public per share of our common stock and the pro forma as adjusted net tangible book value per share of our common stock immediately after the offering.

Net tangible book value (deficit) per share represents our total tangible assets (total assets less intangible assets) less total liabilities and less preferred stock divided by the number of shares of outstanding common stock. The historical net tangible book value (deficit) of our common stock as of September 30, 2013 was $(83.2) million, or $(300.6) per share. Our pro forma net tangible book value as of September 30, 2013 was $33.83 million, or $2.33 per share, based on the total number of shares of our common stock outstanding as of September 30, 2013. Pro forma net tangible book value, before the issuance and sale of shares in this offering, gives effect to: (1) the automatic conversion of the outstanding convertible preferred stock into an aggregate of 14,218,319 shares of common stock immediately prior to the completion of this offering, (2) the cash exercise of warrants to purchase an aggregate of 24,588 shares of common stock, which we expect will occur prior to the closing of this offering as the warrants will otherwise expire at that time and (3) the reclassification of our preferred stock warrant liability to additional paid-in-capital upon the closing of this offering.

After giving effect to our sale of 3,529,411 shares of common stock in this offering at an assumed initial public offering price $17.00 per share, the midpoint of the range reflected on the cover page of this prospectus, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us, our pro forma as adjusted net tangible book value as of September 30, 2013 would have been approximately $87.26 million, or $4.83 per share. This represents an immediate increase in pro forma as adjusted net tangible book value of $2.50 per share to existing stockholders and an immediate dilution of $12.17 per share to investors participating in this offering.

The following table illustrates this dilution on a per share basis to new investors:

Assumed initial public offering price per share		$ 17.00
Historical net tangible book value (deficit) per share as of September 30, 2013, before giving effect to this offering	$ (300.62)	
Increase per share attributable to conversion of convertible preferred stock	$ 302.95	
Pro forma net tangible book value per share as of September 30, 2013, before giving effect to this offering	$ 2.33	
Increase per share attributable to this offering	$ 2.50	
Pro forma net tangible book value, as adjusted to give effect to this offering		$ 4.83
Dilution in pro forma net tangible book value per share to new investors purchasing shares in this offering		$ 12.17

Each $1.00 increase (decrease) in the assumed initial price to the public of $17.00 per share, the midpoint of the range reflected on the cover page of this prospectus, would increase (decrease) the pro forma as adjusted net tangible book value by approximately $3.28 million, or approximately $0.18 per share, and increase (decrease) the dilution per share to investors

Table of Contents

participating in this offering by approximately $0.93 per share, assuming that the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses. We may also increase or decrease the number of shares we are offering. An increase of 1,000,000 in the number of shares offered by us would increase the pro forma as adjusted net tangible book value by approximately $15.8 million, or $15.81 per share, and the dilution per share to investors participating in this offering would be $11.59 per share, assuming that the assumed initial price to the public remains the same, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses. Similarly, a decrease of 1,000,000 shares in the number of shares offered by us would decrease the pro forma as adjusted net tangible book value by approximately $15.8 million, or $15.81 per share, and the dilution per share to investors participating in this offering would be $11.59 per share, assuming that the assumed initial price to the public remains the same, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses. The pro forma as adjusted information discussed above is illustrative only and will adjust based on the actual initial price to the public and other terms of this offering determined at pricing.

The following table summarizes, on the pro forma as adjusted basis as of September 30, 2013 described above, the differences between the number of shares of common stock purchased from us, the total consideration and the weighted-average price per share paid by existing stockholders and by investors participating in this offering. For purposes of this table, only shares sold by us are included in the shares held by investors participating in this offering.

	Shares purchased		Total consideration		Weighted average price per share
	Number	Percent	Amount	Percent	
Existing stockholders before this offering	14,519,525	80.4%	$ 92,298,805	60.6%	$ 6.36
Investors participating in this offering	3,529,411	19.6%	59,999,987	39.4%	$ 17.00
Total	18,048,936	100%	$ 152,298,792	100%	

Each $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) total consideration paid by new investors by approximately $3.83 million, assuming that the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses. We may also increase or decrease the number of shares we are offering. An increase (decrease) of 1,000,000 in the number of shares offered by us would increase (decrease) total consideration paid by new investors by $15.8 million, assuming that the assumed initial price to the public remains the same, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses.

The outstanding share information in the tables above excludes as of September 30, 2013:

- 2,079,338 shares of common stock issuable upon exercise of options outstanding, 1,466,789 of which were vested and then exercisable, at a weighted average exercise price of $1.0876 per share;
- 276,334 shares of common stock issuable upon the exercise of options to purchase common stock granted after September 30, 2013, at a weighted average exercise price of $8.37 per share;

Table of Contents

1,074,415 shares of common stock reserved for future grants under our stock-based compensation plans as of the date of this prospectus, consisting of:

895,346 shares of common stock reserved for future grants under our 2014 Equity Incentive Plan, which will become effective immediately prior to the date of this prospectus, and any shares subject to stock options under our 2012 Equity Incentive Plan or our 2002 Amended Stock Incentive Plan that expire or otherwise terminate without having been exercised in full and any shares issued pursuant to awards granted under such plans that are forfeited to or repurchased by us, with the maximum number of shares to be added to the 2014 Equity Incentive Plan equal to 2,328,569 shares;

179,069 shares of common stock reserved for future issuance under our 2014 Employee Stock Purchase Plan, which will become effective immediately prior to the date of this prospectus; and

Any shares of common stock that become available subsequent to this offering under our 2014 Equity Incentive Plan and 2014 Employee Stock Purchase Plan pursuant to the provisions thereof that automatically increase the shares reserved for issuance under such plans each year, as more fully described in Executive compensation Employee benefit and stock plans; and

268,200 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2013, at a weighted average exercise price of $1.4216 per share, after conversion of the convertible preferred stock.

Table of Contents

Selected financial data

You should read the following selected financial data below in conjunction with Management s discussion and analysis of financial condition and results of operations and the financial statements, related notes and other financial information included elsewhere in this prospectus. The selected financial data in this section are not intended to replace the financial statements and are qualified in their entirety by the financial statements and related notes included elsewhere in this prospectus.

The statements of operations data for the years ended December 31, 2011 and 2012 and the balance sheet data as of December 31, 2011 and 2012 are derived from our audited financial statements included elsewhere in this prospectus. The statements of operations data for the nine months ended September 30, 2012 and 2013 and the balance sheet data as of September 30, 2013 are derived from our unaudited interim financial statements included elsewhere in this prospectus. Our unaudited interim financial statements were prepared on a basis consistent with our audited financial statements and include, in our opinion, all adjustments, consisting only of normal recurring adjustments that we consider necessary for a fair presentation of the financial information set forth in those statements included elsewhere in this prospectus. Our historical results are not necessarily indicative of the results that may be expected in any future period, and our interim results are not necessarily indicative of the results that may be expected for the full year or any other period.

	Year ended December 31,		Nine months ended September 30,	
(amounts in thousands, except share and per share amounts)	**2011**	**2012**	**2012**	**2013**
	(as restated)		**(unaudited)**	
Statements of operations data:				
Total revenue				
Sales revenue	$ 19,076	$ 28,077	20,375	33,043
Rental revenue	10,977	19,872	13,898	21,901
Sales of used rental revenue	46	95	53	200
Other revenue	535	532	409	537
Total revenue	30,634	48,576	34,735	55,681
Cost of revenue				
Cost of sales revenue	12,127	17,359	12,679	18,309
Cost of rental revenue	3,783	7,243	5,122	8,459
Cost of used rental equipment sales	20	25	20	97
Total cost of revenue	15,930	24,627	17,821	26,865
Gross profit	14,704	23,949	16,914	28,816
Operating expenses:				
Research and development	1,789	2,262	1,731	1,817
Sales and marketing	9,014	12,569	8,753	13,292
General and administrative	5,623	8,289	5,805	9,796
Total operating expenses	16,426	23,120	16,289	24,905

Income (loss) from operations	(1,722)	829	625	3,911
Other expense, net	(267)	(247)	(149)	(296)
Income (loss) before provision for income taxes	(1,989)	582	476	3,615
Provision for income taxes	13	18	20	151
Net income (loss)	(2,002)	564	456	3,464
Less deemed dividend on redeemable convertible preferred stock	(3,027)	(5,781)	$ (4,119)	$ (5,359)
Net loss attributable to common stockholders	$ (5,029)	$ (5,217)	$ (3,663)	$ (1,895)

Table of Contents

(amounts in thousands, except share and per share amounts)	Year ended December 31, 2011	Year ended December 31, 2012	Nine months ended September 30, 2012	Nine months ended September 30, 2013
		(as restated)	(unaudited)	
Net loss attributable to common stockholders:(1)				
Basic:	$ (20.15)	$ (19.97)	$ (14.02)	$ (6.91)
Diluted:	$ (20.15)	$ (19.97)	$ (14.02)	$ (6.91)
Weighted average shares used in computing net loss per share attributable to common stockholders:(1)				
Basic:	249,519	261,268	261,216	274,357
Diluted:	249,519	261,268	261,216	274,357
Unaudited pro forma net income (loss) per share attributable to common stockholders:(1)				
Basic:		$ 0.04		$ 0.24
Diluted:		$ 0.04		$ 0.21
Unaudited weighted average shares used in computing pro forma net income per share attributable to common stockholders:				
Basic:		14,601,861		14,516,523
Diluted:		15,486,487		16,350,527
Other financial data:				
EBITDA(2)	$ 1,357	$ 5,971	$ 4,224	$ 9,913
Adjusted EBITDA(2)	$ 1,620	$ 5,883	$ 4,124	$ 10,231

(1) See note 2 to each of our audited and unaudited financial statements included elsewhere in this prospectus for an explanation of the calculations of our basic and diluted net loss per share attributable to common stockholders and pro forma net loss per share attributable to common stockholders.

(2) For a discussion of our use of EBITDA and Adjusted EBITDA and their calculations, please see Non GAAP financial measures.

(amounts in thousands)	2011	Year ended December 31, 2012	2012	Nine months ended September 30, 2013
		(as restated)	(unaudited)	
Balance sheet data:				
Cash and cash equivalents	$ 3,906	$ 15,112	$ 17,098	$ 17,059
Working capital	1,302	12,880	15,297	12,352
Total assets	24,131	47,586	47,246	60,862
Total indebtedness	9,629	8,936	9,619	12,027
Deferred revenue	594	1,094	851	1,961
Total liabilities	16,575	19,011	19,043	26,667
Redeemable convertible preferred stock	83,122	109,345	107,431	116,744
Total stockholders deficit	75,566	80,770	79,228	82,549

Non-GAAP financial measures

EBITDA and Adjusted EBITDA are a financial measures that are not calculated in accordance with generally accepted accounting principles in the United States, or GAAP. We define EBITDA as net income or loss excluding interest income, interest expense, taxes and depreciation and amortization. Adjusted EBITDA also excludes the change in the fair value of our preferred stock warrant liability and stock-based compensation. Below, we have provided a reconciliation of EBITDA and Adjusted EBITDA to our net income or loss, the most directly comparable financial measure calculated and presented in accordance with GAAP. EBITDA and Adjusted EBITDA

Table of Contents

should not be considered alternatives to net income or loss or any other measure of financial performance calculated and presented in accordance with GAAP. Our EBITDA and Adjusted EBITDA may not be comparable to similarly titled measures of other organizations because other organizations may not calculate EBITDA and Adjusted EBITDA in the same manner as we calculate these measures.

We include EBITDA and Adjusted EBITDA in this prospectus because they are important measures upon which our management assesses our operating performance. We use EBITDA and Adjusted EBITDA as key performance measures because we believe they facilitate operating performance comparisons from period to period by excluding potential differences primarily caused by variations in capital structures, tax positions, the impact of depreciation and amortization expense on our fixed assets, changes related to the fair value remeasurements of our preferred stock warrant, and the impact of stock-based compensation expense. Because EBITDA and Adjusted EBITDA facilitate internal comparisons of our historical operating performance on a more consistent basis, we also use EBITDA and Adjusted EBITDA for business planning purposes, to incentivize and compensate our management personnel, and in evaluating acquisition opportunities. In addition, we believe EBITDA and Adjusted EBITDA and similar measures are widely used by investors, securities analysts, ratings agencies, and other parties in evaluating companies in our industry as a measure of financial performance and debt-service capabilities.

Our use of EBITDA and Adjusted EBITDA have limitations as analytical tools, and you should not consider them in isolation or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

- EBITDA and Adjusted EBITDA do not reflect our cash expenditures for capital equipment or other contractual commitments;
- Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and EBITDA and Adjusted EBITDA do not reflect capital expenditure requirements for such replacements;
- EBITDA and Adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital needs;
- EBITDA and Adjusted EBITDA do not reflect the interest expense or the cash requirements necessary to service interest or principal payments on our indebtedness; and
- Other companies, including companies in our industry, may calculate EBITDA and Adjusted EBITDA measures differently, which reduces their usefulness as a comparative measure.

In evaluating EBITDA and Adjusted EBITDA, you should be aware that in the future we will incur expenses similar to the adjustments in this presentation. Our presentation of EBITDA and Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by these expenses or any unusual or non-recurring items. When evaluating our performance, you should consider EBITDA and Adjusted EBITDA alongside other financial performance measures, including our net loss and other GAAP results.

Table of Contents

The following table presents a reconciliation of EBITDA and Adjusted EBITDA to our net income or loss, the most comparable GAAP measure, for each of the periods indicated:

EBITDA and Adjusted EBITDA (in thousands)	Year ended December 31, 2011	Year ended December 31, 2012	Nine months ended September 30, 2012	Nine months ended September 30, 2013
		(as restated)	(unaudited)	
Net income (loss)	$ (2,002)	$ 564	$ 456	$ 3,464
Non-GAAP adjustments:				
Interest income	(113)	(88)	(84)	(9)
Interest expense	261	493	381	312
Provision for income taxes	13	18	20	151
Depreciation and amortization	3,198	4,984	3,451	5,995
EBITDA	1,357	5,971	4,224	9,913
Change in fair value of preferred stock warrant liability	119	(148)	(148)	202
Stock-based compensation	144	60	48	116
Adjusted EBITDA	$ 1,620	$ 5,883	$ 4,124	$ 10,231

Table of Contents

Management s discussion and analysis of financial condition and results of operations

You should read the following discussion and analysis of our financial condition and results of operations together with the financial statements and the related notes thereto included elsewhere in this prospectus. This discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results may differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this prospectus, particularly in the section of the prospectus entitled Risk factors and Special note regarding forward-looking statements.

Overview

We are a medical technology company that develops, manufactures and markets innovative portable oxygen concentrators used to deliver supplemental long-term oxygen therapy to patients suffering from chronic respiratory conditions. Traditionally, these patients have relied on stationary oxygen concentrator systems for use in the home and oxygen tanks or cylinders for mobile use. The tanks and cylinders must be delivered regularly and have a finite amount of oxygen, which limits patient mobility and requires patients to plan activities outside of their homes around delivery schedules. Additionally, patients must attach long, cumbersome tubing to their stationary concentrators simply to enable mobility within their homes. We refer to this traditional delivery approach as the delivery model. Our proprietary Inogen One systems are portable devices that concentrate the air around them to offer a single source of supplemental oxygen anytime, anywhere. Using our systems, patients can eliminate their dependence on stationary concentrators and tank and cylinder deliveries, thereby improving quality-of-life and fostering mobility.

In May 2004, we received 510(k) clearance from the U.S. Food and Drug Administration, or the FDA, for our Inogen One G1. Since we launched the Inogen One G1 in 2004, through 2008, we derived our revenue almost exclusively from sales to healthcare providers and distributors. In December 2008, we acquired Comfort Life Medical Supply, LLC in order to secure access to the Medicare rental market and began accepting Medicare reimbursement for our oxygen solutions in certain states. At the time of the acquisition, Comfort Life Medical Supply, LLC had an active Medicare billing number but few other assets and limited business activities. In January 2009, following the acquisition of Comfort Life Medical Supply, LLC, we initiated our direct-to-consumer marketing strategy and began selling Inogen One systems directly to patients and building our Medicare rental business in the United States. In April 2009, we became a Durable, Medical Equipment, Prosthetics, Orthotics, and Supplies accredited Medicare supplier by the Accreditation Commission for Health Care for our Goleta, California facility for Home/Durable Medical Equipment Services for oxygen equipment and supplies. We believe we are the only portable oxygen concentrator manufacturer that employs a direct-to-consumer marketing strategy in the United States, meaning we advertise directly to patients, process their physician paperwork, provide clinical support as needed and bill Medicare or insurance on their behalf.

We believe our direct-to-consumer strategy has been critical to driving patient adoption of our technology. All other portable oxygen concentrator manufacturers access patients through home medical equipment providers, which we believe are disincentivized to encourage portable oxygen concentrator adoption. In order to facilitate the regular delivery and pickup of oxygen tanks, home medical equipment providers have invested in geographically dispersed distribution

Table of Contents

infrastructures consisting of delivery vehicles, physical locations, and delivery personnel within each area. Because portable oxygen concentrator technology eliminates the need for physical distribution infrastructure but has higher initial equipment costs than oxygen tanks and cylinders, we believe converting to a portable oxygen concentrator model would require both significant restructuring and capital investment for home medical equipment providers. Our direct-to-consumer marketing strategy allows us to sidestep the home medical equipment channel, appeal to patients directly, and capture both the manufacturing and provider margin. We believe our ability to capture this top-to-bottom margin, combined with our portable oxygen concentrator technology that eliminates the need for the costs associated with oxygen deliveries, gives us a cost structure advantage over our competitors using the delivery model.

We derive a majority of our revenue from the sale and rental of our Inogen One systems and related accessories to patients, insurance carriers, home healthcare providers and distributors. We sell multiple configurations of our Inogen One systems with various batteries, accessories, warranties, power cords, and language settings. We also rent our products to Medicare beneficiaries and patients with other insurance coverage to support their oxygen needs as prescribed by a physician as part of a care plan. Our goal is to design, build and market oxygen solutions that redefine how oxygen therapy is delivered. To accomplish this goal and to grow our revenue, we intend to continue to:

Expand our sales and marketing channels. We will continue to hire additional internal sales representatives to drive our direct-to-consumer marketing efforts. During the year ended December 31, 2013, we increased our internal sales force from 93 to 108. Additionally, we are building a physician referral channel that currently consists of ten employees. Lastly, we are focused on building our international distribution capabilities.

Invest in our product offerings to develop innovative products. We expended $1.8 million and $2.3 million in 2011 and 2012, respectively, in research and development expenses, and we intend to continue to make such investments in the foreseeable future.

Secure contracts with healthcare payors and insurers. Based on our patient population, we estimate that at least 30% of oxygen therapy patients are covered by non-Medicare payors, and that these patients often represent a younger, more active patient segment. By becoming an in-network provider with more insurance companies, we can reduce the co-pay for patients, which we believe will allow us to attract additional patients to our Inogen One solutions.

We have been developing and refining the manufacturing of our Inogen One Systems over the past eight years. While nearly all of our manufacturing and assembly processes were originally outsourced, assembly of the manifold, compressor, sieve bed and concentrator is now conducted in-house in order to improve quality control and reduce cost. Additionally, we use lean manufacturing practices to maximize manufacturing efficiency. We rely on third-party manufacturers to supply several components of our Inogen One Systems. We typically enter into supply agreements for these components that specify quantity, quality requirements and delivery terms. In certain cases, these agreements can be terminated by either party upon relatively short notice. We have elected to source certain key components from single sources of supply, including our batteries, bearings, carry bags, motors, pistons, valves, and molded plastic components. While alternative sources of supply are readily available for these components, we believe that maintaining a single-source of supply allows us to control production costs and inventory levels, and to manage component quality.

Table of Contents

Historically, we have generated a majority of our revenue from sales and rentals to customers in the United States. In 2011 and 2012, approximately 26% and 27%, respectively, of our total revenue was from customers outside the United States, primarily in Europe. To date, all of our revenue has been denominated in United States dollars. We sell our products in 41 countries outside the United States through distributors or directly to large house accounts, which include gas companies and home oxygen providers. In this case, we sell to and bill the distributor or house accounts directly, leaving responsibility for the patient billing, support and clinical setup to the local provider. As of January 1, 2014, we have four employees who focus on selling our products to distributors and house accounts outside the United States.

Our total revenue increased to $48.6 million in 2012 from $10.7 million in 2009, due to growth in rental revenue associated with an increase in the number of patients using Medicare or private payors to rent our products, and growth in sales revenue associated with the increases in international sales and direct-to-consumer cash sales of our Inogen One systems and new product launches. In 2010 our total revenue was $23.6 million and in 2011 our total revenue was $30.6 million. We generated Adjusted EBITDA of $1.6 million and $5.9 million in 2011 and 2012, respectively. We generated a net loss of $2.0 million in 2011 and net income of $0.6 million in 2012. For the nine months ended September 30, 2013, we had total revenue and net income of $55.7 million and $3.5 million, respectively. As of September 30, 2013, our accumulated deficit was $82.6 million.

The vast majority of our revenue consists of sales revenue and rental revenue.

Sales revenue

Our future financial performance will be driven in part by the growth in sales of our Inogen One systems, and, to a lesser extent, sales of batteries and other accessories. We plan to grow our system sales in the coming years through multiple strategies, including: expanding our direct-to-consumer sales efforts through hiring additional sales representatives, investing in consumer awareness, expanding our sales infrastructure and efforts outside of the United States and enhancing our product offerings through additional product launches. As our product offerings grow, we solicit feedback from our customers and focus our research and development efforts on continuing to improve patient preference and reduce the total cost of the product, in order to further drive sales of our products.

Our direct-to-consumer sales process involves numerous interactions with the individual patient, the physician and the physician s staff, and includes an in-depth analysis and review of our product, the patient s diagnosis and prescribed oxygen therapy, including procuring an oxygen prescription, and assessing the patient s available insurance benefits. The patient may consider whether to finance the product through an Inogen-approved third party or whether to purchase the equipment. Product is not deployed until both the prescription and payment are received. Once product is deployed, the patient has 30 days to return the product under a trial, subject to the patient payment of a minimal processing and handling fee. Approximately 5% to 10% of patients who purchase a system for cash return the system during this 30-day trial period. As a result, we have experienced fluctuations in our direct-to-consumer sales on a period-to-period basis in the past, a trend that we anticipate will continue in the future.

Our business-to-business efforts are focused on selling to home medical equipment distributors, oxygen providers and resellers who are primarily based outside of the United States. This process involves interactions with various key customer stakeholders, including sales, purchasing, product

Table of Contents

testing, and clinical personnel. Businesses that have patient demand that can be met with our portable oxygen concentrator systems place purchase orders to secure product deployment. This may be influenced based on outside factors, including the result of tender offerings, changes in insurance plan coverage, and overall changes in the net oxygen therapy patient population. Products are shipped FOB Inogen, and based on financial history and profile, businesses may either prepay or receive extended terms. As a result of these factors, product purchases can be subject to changes in demand by customers. Given the potential for variability in ordering history that we have in the past experienced, and likely will in the future experience, there may be fluctuations in our business-to-business sales on a period-to-period basis.

We sold more than 7,300 Inogen One systems in 2011 and 11,900 Inogen One systems in 2012. Management focuses on system sales as an indicator of current business success.

Rental revenue

Our rental process involves numerous interactions with the individual patient, the physician and the physician s staff. The process includes an in-depth analysis and review of our product, the patient s diagnosis and oxygen needs, and their medical history to confirm the appropriateness of our product for the patient s oxygen therapy and compliance with Medicare and private payor billing requirements, which often necessitates additional physician evaluation and/or testing as well as a Certificate of Medical Necessity. Once the product is deployed, the patient receives direction on product use and receives a clinical titration from our trained staff to confirm the product meets the patient s needs prior to billing. As a result, the time from initial contact with a customer to billing can vary significantly and be up to one month or longer.

We plan to grow our rental revenue in the coming years through multiple strategies, including expanding our direct-to-consumer marketing efforts through hiring additional sales representatives and investing in patient awareness and physician-based sales, securing additional insurance contracts and continuing to enhance our product offerings through additional product launches. In addition, patients may come off of our services due to death, a change in their condition, a change in location, a change in provider or other factors. In each case, we maintain asset ownership and can redeploy assets as appropriate following such events. Given the length and uncertainty of our patient acquisition cycle and potential returns we have in the past experienced, and likely will in the future experience, there may be fluctuations in our net new patient setups on a period-to-period basis.

As the rental patient base increases, this rental model generates recurring revenue with minimal additional sales and general and administrative expenses. A portion of rentals include a capped rental period when no additional reimbursement will be allowed unless additional criteria are met. In this scenario, the ratio of billable patients to patients on service is critical to maintaining rental revenue growth as patients on service increases. As the rental base expands, we expect our rental revenue to increase and over time to become an increasingly important contributor to our total revenue. Over time, we believe that our rental revenue should be subject to less period-to-period fluctuation than our sales revenue.

As of December 31, 2012, we had over 13,500 oxygen rental patients, an increase from over 7,500 oxygen rental patients as of December 31, 2011. Management focuses on rental revenue as an indicator of current business success and a leading indicator of likely future rental revenue; however, actual rental revenue recognized is subject to a variety of other factors, including reimbursement levels by patient zip code, the number of capped patients, and adjustments for patients in transition.

Table of Contents

Reimbursement

We rely heavily on reimbursement from Medicare, and secondarily from private payors and Medicaid, for our rental revenue. For the nine months ended September 30, 2013, approximately 73% of our rental revenue was derived from Medicare reimbursement. The U.S. Medicare list price for our stationary oxygen rentals (E1390) is $260 per month and for our oxygen generating portable equipment (OGPE) rentals (E1392) is $70 per month. The current standard Medicare allowable effective January 1, 2014 for stationary oxygen rentals (E1390) is $178.24 per month and for OGPE rentals (E1392) is $51.63 per month. These are the two primary codes that we bill to Medicare and other payors for our product rentals.

As of January 1, 2011, Medicare has phased in a program called competitive bidding. Competitive bidding impacts the amount Medicare pays suppliers of durable medical equipment, including portable oxygen concentrators. The program is defined geographically, with suppliers submitting bids to provide medical equipment for a specific product category within that geography. Once bids have been placed, an individual company s bids across products within the category are aggregated and weighted by each product s market share in the category. The weighted average price is then indexed against competitors. Medicare determines a clearing price out of these weighted average prices at which sufficient suppliers have indicated they will support patients in the category, and this threshold is typically designed to generate theoretical supply that is twice the expected demand. Bids for each modality among the suppliers that made the cut are then arrayed to determine what Medicare will reimburse for each product category. The program has strict anti-collusion guidelines to ensure bidding is truly competitive. Competitive bidding contracts last three years once implemented, after which they are subject to a new round of bidding. Discounts off the standard Medicare allowable occur in competitive bidding Metropolitan Statistical Areas where contracts have been awarded as well as in cases where private payors pay less than this allowable. Current Medicare payment rates in competitive bidding areas are at 48-64% of the standard Medicare allowable for stationary oxygen rentals (average of $93.29 per month) and OGPE rentals are at 70-92% of the standard Medicare allowable (average of $42.33 per month). Competitive bidding rates are based on the zip code where the patient resides. Rental revenue includes payments for product, disposables, and customer service/support.

The following table sets forth the current Medicare standard allowable reimbursement rates and the weighted average reimbursement rates applicable in Metropolitan Statistical Areas covered by rounds one and two of competitive bidding. The round one re-compete was completed in the same Metropolitan Statistical Areas as round one for the next three year period starting 1/1/14 when the original contracts expire.

	Medicare standard allowable effective 1/1/14	**Round one weighted average 1/1/11-12/11/13**	**Round two weighted average 7/1/13-6/30/16**	**Round one re-compete weighted average 1/1/14-12/31/16**
E1390	$ 178.24	$ 116.16	$ 93.10	$ 95.74
E1392	51.63	41.89	42.69	38.08
Total	$ 229.87	$ 158.05	$ 135.79	$ 133.82
% of standard		*69%*	*59%*	*58%*

Table of Contents

In addition to reducing the Medicare reimbursement rates in the Metropolitan Statistical Areas, the competitive bidding program has effectively reduced the number of oxygen suppliers that can participate in the Medicare program. We believe that more than 75% of existing oxygen suppliers were eliminated in round one of competitive bidding, which was implemented January 1, 2011 in 9 Metropolitan Statistical Areas. Round two of competitive bidding was implemented July 1, 2013 in 91 Metropolitan Statistical Areas and we believe the impact on the number of oxygen suppliers will be similar when released. We believe that 59% of the market was covered by round one and round two of competitive bidding.

Cumulatively in rounds one, two and round one re-compete, we were offered contracts for a substantial majority of the competitive bidding areas and products for which we submitted bids. However, there is no guarantee that we will garner additional market share as a result of these contracts. The contracts include products that may require us to subcontract certain services or products to third parties, which must be approved by the Centers for Medicare & Medicaid Services.

Following round one of competitive bidding, we were excluded from the Kansas City-MO-KS, Miami-Fort Lauderdale-Pompano-FL, and Orlando Kissimmee-FL competitive bidding areas and Honolulu-Hawaii, where we have never maintained a license. After round one recompete, we gained access to Kansas City-MO-KS and were excluded from the following competitive bidding areas: Cleveland-Elyria-Mentor-OH, Cincinnati-Middletown-OH, Miami-Fort Lauderdale-Pompano-FL, Orlando Kissimmee-FL, Pittsburg-PA, Riverside-San Bernardino-Ontario-CA. After round two of competitive bidding, we were excluded from an additional 10 competitive bidding areas, including Akron-OH, Cape Coral-Fort Myers-FL, Deltona-Daytona Beach-Ormond Beach-FL, Jacksonville-FL, Lakeland-Winter Haven-FL, North Port-Bradenton-Sarasota-FL, Ocala, Palm Bay-Melbourne-Titusville-FL, Tampa-St. Petersburg-Clearwater-FL and Toledo-OH. Collectively, we have incrementally lost access to approximately seven percent of the Medicare market. As a result, on a going forward basis we will continue to have access to approximately 90% of the Medicare market based on our analysis of the 92 competitive bidding areas that we have won out of the 109 competitive bidding areas, representing 59% of the market, with the remaining 41% of the market not subject to competitive bidding. The incremental loss of access to approximately seven percent of the Medicare market is expected to have an adverse impact on our rental business, which represented approximately 40% of our total revenue in the three and nine months ended on September 30, 2013. However, we expect the decline in total revenue resulting from the loss of competitive bidding contract in the areas that we were excluded from to be partially offset by the grandfathering of existing Medicare patients and direct sales to former Medicare patients with third party insurance coverage or who pay cash. Our revenue from Medicare in the 17 competitive bidding areas where we were not offered contracts was approximately $1.0 million in 2012 and $1.3 million in the nine months ended September 30, 2013.

Under the Medicare competitive bidding program, oxygen therapy providers may grandfather existing patients on service up to the implementation date of competitive bidding program. This means oxygen therapy providers may retain all existing patients and continue to receive reimbursement for them so long as the new reimbursement rate is accepted and the applicable beneficiary chooses to continue to receive equipment from the provider. Providers must either keep or release all patients under this grandfathering arrangement in each competitive

bidding area; specific individual selection of patients for retention or release is not allowed.

Table of Contents

Providers can continue to sell equipment in competitive bid areas where they were not awarded contracts to patients paying with cash or third-party insurance coverage.

We have elected to grandfather and retain all patients in competitive bid areas where contracts were not awarded to us. In addition, we plan to continue to accept patients in competitive bidding areas where we did not receive contracts through private insurance. We will also pursue retail sales of our equipment to patients in those areas.

For rental equipment, Medicare reimbursement for oxygen equipment is limited to a maximum of 36 months, after which time the equipment continues to be owned by the home oxygen provider for as long as the patient s medical need exists. The provider that billed Medicare for the 36th month continues to be responsible for the patient s care for months 37 through 60, and there is generally no additional reimbursement for oxygen generating portable equipment for these later months. The Centers for Medicare & Medicaid Services does not reimburse suppliers for oxygen tubing, cannulas and supplies that may be required for the patient. The provider is required to keep the equipment provided in working order and in some cases the Centers for Medicare & Medicaid Services will reimburse for repair costs. After the five year useful life is reached, the patient may request replacement equipment and, if he or she can be re-qualified for the Medicare benefit, a new maximum 36-month rental period would begin. The supplier may not arbitrarily issue new equipment. We cannot state with certainty the number of patients in the capped rental period or the potential impact to revenue associated with patients in the capped rental period.

Our obligations to service assigned Medicare patients over the contract rental period include supplying working equipment that meets the patient s oxygen needs pursuant to their doctor s prescription and certificate of medical necessity form and supplying all disposables required for the patient to operate the equipment, including cannulas, filters, replacement batteries, carts and carry bags, as needed. If the equipment malfunctions, we must repair or replace the equipment. We determine what equipment the patient receives, and we can deploy existing used assets as long as the doctor s requirements are met. We must also procure a recertification certificate of medical necessity from the patient s doctor to confirm the patient s need for oxygen therapy one year after first receiving oxygen therapy and one year after each new 36-month reimbursement period begins. These contracts are cancellable by the patient at any time and by the provider at any time as long as the patient can transition to another provider.

In addition to the adoption of the competitive bidding program, reimbursable fees for oxygen rental services in non-competitive bidding areas were eligible to receive mandatory annual Consumer Price Index for all Urban Consumers, or CPI-U, updates beginning in 2010. The CPI-U for 2012 was +3.6%, but the multi-factor productivity adjustment remained -1.2%, so the net result was a 2.4% increase in fee schedule payments in 2012 for items and services not included in an area subject to competitive bidding. For 2013, the CPI-U is +1.7%, but the adjustment is -0.9%, so the net result is a 0.8% increase in fee schedule payments in 2013. For 2014, the CPI-U is +1.8%, but the adjustment is -0.8%, so the net result is a 1.0% increase in fee schedule payments in 2014. However, the stationary oxygen equipment codes payment amounts, as required by statute, must be adjusted on an annual basis, as necessary, to ensure budget neutrality of the new payment class for oxygen generating portable equipment. Thus, the increase in allowable payment amounts for stationary oxygen equipment codes increased 0.5% from 2013 to 2014. At this time, it is unclear if the current CPI-U method or a proposed inflation method included in President Obama s 2014 fiscal budget proposal would apply to future year s calculations.

Table of Contents

As of September 30, 2013, we had 30 contracts with Medicaid and private payors. These contracts qualify us an in-network provider for these payors. As a result, patients can use our systems at the same cost as other in-network oxygen therapy solutions, including those utilizing the delivery model. Based on our patient population, we believe at least 30% of all oxygen therapy patients are covered by private payors. Private payors typically provide reimbursement at 60% to 100% of Medicare allowables for in-network plans, and private payor plans have 36-month caps similar to Medicare. We anticipate that private payor reimbursement levels will generally be reset in accordance with Medicare payment amounts established through competitive bidding.

We cannot predict the full extent to which reimbursement for our products will be affected by competitive bidding or by initiatives to reduce costs for private payors. We believe that we are well positioned to respond to the changing reimbursement environment because our product offerings are innovative, patient-focused and cost-effective. We have historically been able to reduce our costs through scalable manufacturing, better sourcing, continuous innovation, and reliability improvements, as well as innovations that reduce our product service costs by minimizing exchanges, such as user replaceable batteries and oxygen filtration cartridges. As a result of bringing manufacturing and assembly largely in-house and our commitment to driving efficient manufacturing processes, we have reduced our overall system cost by 36% since 2009. We intend to continue to seek ways to reduce our cost of revenue through manufacturing and design improvements.

Basis of presentation

The following describes the line items set forth in our statements of operations.

Revenue

We classify our revenue in four main categories: sales revenue, rental revenue, sale of used rental equipment and other revenue. There will be fluctuations in mix between business-to-business sales, direct-to-consumer sales and rentals from period to period. We expect rental revenue should constitute a larger percentage of total revenue, which would increase our gross margins. In addition, we expect both the average selling price and the manufacturing cost of our products to decrease following the introduction of future generations of our Inogen One systems. Inogen One system selling prices and gross margins for our Inogen One systems may fluctuate as we introduce new products and reduce our product costs. For example, the gross margin for our Inogen One G3 is higher than our Inogen One G2. Thus, to the extent our sales of our Inogen One G3 systems are higher than sales of our Inogen One G2 systems, our overall gross margins should improve and, conversely, to the extent our sales of our Inogen One G2 systems are higher than sales of our Inogen One G3 systems, our overall gross margins should decline.

Sales revenue. Our sales revenue is derived from the sale of our Inogen One systems and related accessories to patients in the United States and to home healthcare providers, distributors and resellers worldwide. Sales revenue is classified into two areas: business-to-business sales and direct-to-consumer sales. Business-to-business sales were 67% of sales revenue in 2011 and 68% of sales revenue in 2012. For the nine months ended September 30, 2012 and 2013, business-to-business sales as a percentage of sales revenue were 69% and 61%, respectively. Generally, our direct-to-consumer sales have higher margins than our business-to-business sales.

Rental revenue. Our rental revenue is derived from the rental of our Inogen One systems to patients through Medicare, private payors and Medicaid, which typically also include a patient

responsibility component for patient co-insurance and deductibles. Generally, our product rentals have higher gross margins than our product sales.

Sales of used rental equipment. Our sales of used rental equipment revenue is derived from the sale of our Inogen One systems and related accessories to home healthcare providers and patients when the product has previously been sold or rented to another patient or business. Sales in this category are not material.

Other revenue. Other revenue consists of service and freight revenue. Revenue from the sales of our services is recognized when no significant obligations remain undelivered and collection of the receivables is reasonably assured. We offer extended service contracts on our Inogen One concentrator line for periods ranging from 12 to 24 months after the end of the standard warranty period. Revenue from these extended service contracts is recognized in income on a straight-line basis over the contract period.

We also offer a lifetime warranty for direct-to-consumer sales. For a fixed price, we agree to provide a fully functional oxygen concentrator for the remaining life of the patient. Lifetime warranties are only offered to patients upon the initial sale of oxygen equipment by us, and are non-transferable. Product sales with lifetime warranties are considered to be multiple element arrangements within the scope of ASC 605-25.

There are two deliverables when a product that includes a lifetime warranty is sold. The first deliverable is the oxygen concentrator equipment which comes with a standard warranty of three years. The second deliverable is the lifetime warranty that provides for a functional oxygen concentrator for the remaining lifetime of the patient. These two deliverables qualify as separate units of accounting.

The revenue is allocated to the two deliverables on a relative selling price method. We have vendor-specific objective evidence of selling price for the equipment. To determine the selling price of the lifetime warranty, we use our best estimate of the selling price for that deliverable as the lifetime warranty is neither separately priced nor selling price is available through third-party evidence. To calculate the selling price associated with the lifetime warranties, management considered the profit margins of the overall business, the average estimated cost of lifetime warranties and the price of extended warranties. A significant estimate used to calculate the price and expense of lifetime warranties is the life expectancy of patients. Based on clinical studies, we estimate that 60% of patients will succumb to their disease within three years. Given the approximate mortality rate of 20% per year, we estimate on average all patients will succumb to their disease within five years. We have taken into consideration that when patients decide to buy an Inogen portable oxygen concentrator with a lifetime warranty, they typically have already been on oxygen for a period of time, which can have a large impact on their life expectancy from the time our product is deployed.

After applying the relative selling price method, revenue from equipment sales is recognized when all other revenue recognition criteria for product sales are met. Lifetime warranty revenue is recognized using the straight-line method during the fourth and fifth year after the delivery of the equipment which is the estimated usage period of the contract based on the average patient life expectancy.

Freight revenue consists of fees associated with the deployment of products internationally or domestically, when expedited freight options or minimum order quantities are not met. Freight revenue is a percentage markup of freight costs.

Table of Contents

Cost of revenue

Cost of sales revenue and cost of used rental equipment sales consists primarily of costs incurred in the production process, including costs of component materials, assembly labor and overhead, warranty, provisions for slow-moving and obsolete inventory and delivery costs for items sold. Cost of rental revenue consists primarily of depreciation expense and service costs for rental assets, including material, labor, freight, consumable disposables and logistics costs. We provide a three-year or lifetime warranty on Inogen One systems sold, and we establish a reserve for warranty repairs based on historical warranty repair costs incurred. Provisions for warranty obligations, which are included in cost of sales revenue, are provided for at the time of shipment. We expect the average unit costs of our Inogen One systems to decline in future periods as a result of our ongoing efforts to develop lower-cost Inogen One systems and to improve our manufacturing processes, reduced rental service costs and expected increases in production volume and yields.

Operating expenses

Research and development

Research and development expenses consist primarily of personnel-related expenses, including salaries, benefits and stock-based compensation, allocated facility costs, laboratory supplies, consulting fees and related costs, costs associated with patent amortization costs, patent legal fees including defense costs and testing costs for new product launches. We have made substantial investments in research and development since our inception. Our research and development efforts have focused primarily on the tasks required to enhance our technologies and to support development and commercialization of new and existing products. We expect to have moderate increases in research and development expense over time.

Sales and marketing

Our sales and marketing expenses primarily support our direct-to-consumer strategy. Our sales and marketing expenses consist primarily of personnel-related expenses, including salaries, commissions, benefits, and stock-based compensation, for employees, and allocated facilities costs. They also include expenses for media and advertising, informational kits, public relations and other promotional and marketing activities, including travel and entertainment expenses, as well as customer service and clinical services. Sales and marketing expenses increased throughout 2012 primarily due to an increase in the sales force and the increasing number of rental patients and we expect a further increase in 2013 as we continue to increase sales and marketing activities.

General and administrative

General and administrative expenses consist primarily of personnel-related expenses, including salaries, benefits, and stock-based compensation for employees in our compliance, finance, medical billing, human resources, information technology, business development and general management functions, and allocated facilities costs. In addition, general and administrative expenses include professional services, such as legal, consulting and accounting services. We expect general and administrative expenses to increase in future periods as the number of administrative personnel grows and we continue to introduce new products, broaden our customer base and grow our business. We also expect legal, accounting and compliance costs to increase due to costs associated with our initial public offering and with being a public company.

Table of Contents

Other income (expense), net

Other income (expense), net consists primarily of interest expense related to our revolving credit and term loan agreement and interest income driven by the interest accruing on cash and cash equivalents and on past due customer balances. Other income (expense) also includes the change in valuation of warrant liability based on the Monte Carlo valuation model.

Result of operations

Comparison of nine months ended September 30, 2012 and 2013 and

selected three months ended September 30, 2012 and 2013

Revenue

(dollars in thousands)	Nine months ended September 30, 2012	2013	Change 2012 v. 2013 $	%
Revenue:				
Sales revenue	$ 20,375	$ 33,043	$ 12,668	62.2%
Rental revenue	13,898	21,901	8,003	57.6%
Sales of used equipment	53	200	147	277.4%
Other revenue	409	537	128	31.3%
Total revenue	$ 34,735	$ 55,681	$ 20,946	60.3%

(dollars in thousands)	Three months ended September 30, 2012	2013	Change 2012 v. 2013 $	%
Revenue:				
Sales revenue	$ 7,342	$ 11,917	$ 4,575	62.3%
Rental revenue	5,639	7,643	2,004	35.5%
Sales of used equipment	14	55	41	292.9%
Other revenue	156	162	6	3.8%
Total revenue	$ 13,151	$ 19,777	$ 6,626	50.4%

The increase in sales revenue in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2013 was attributable to an increase in the number of systems sold primarily related to the launch of the Inogen One G3, an increase in direct-to-consumer sales in the United States due to increased sales and marketing efforts, and an increase in business-to-business sales worldwide as the adoption of portable oxygen concentrators improved. The average selling price of our products was relatively flat at a 1% decrease period-to-period. We experienced price erosion of 5% in business-to-business sales and 6% in direct-to-consumer sales. This effects of this erosion were partially offset by increased sales volumes and an increased proportion of higher average selling price direct-to-consumer sales, which have a higher average selling price. The increase in sales revenue of 62.3% in the comparison of the three months ended September 30, 2012 and 2013 was consistent with the 62.2% increase seen in the comparison of the nine months ending September 30, 2012 versus 2013.

The increase in rental revenue in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2013 was attributable to the increase in rental patients from

Table of Contents

over 11,700 as of September 30, 2012 to over 19,200 as of September 30, 2013 due to additional marketing efforts and increased sales personnel. This increase was partially offset by the reduced reimbursement rates resulting from the associated with round two Competitive Bidding that became effective in 91 Metropolitan Statistical Areas on July 1, 2013. As a result of the reduced reimbursement rates, rental revenue for the three months ended September 30, 2013 was $7.6 million, compared to $5.6 million for the three months ended September 30, 2012, representing a period over period increase of approximately 35.5%. The period over period increase for the three month period was significantly less than the period over period increase for the nine month period of 57.6%. We expect this trend to continue for the next several fiscal quarters. As expected, the growth in sales revenue was not impacted by the reduced reimbursement rates resulting from competitive bidding. Sales revenue grew 62.3% for the three month period ended September 30, 2013 compared to the three month period ended September 30, 2012, compared to 62.2% for the nine month period ended September 30, 2013 compared to the nine month period ended September 30, 2012.

Cost of revenue and gross profit

	Nine months ended September 30,		Change 2012 v. 2013	
(dollars in thousands)	**2012**	**2013**	**$**	**%**
Cost of sales revenue	$ 12,679	$ 18,309	$ 5,630	44.4%
Cost of rental revenue	5,122	8,459	3,337	65.2%
Cost of used rental equipment sales	20	97	77	385.0%
Total cost of revenue	17,821	26,865	9,044	50.7%
Gross profit	$ 16,914	$ 28,816	$ 11,902	70.4%
Gross margin %	*48.7%*	*51.8%*		

Cost of revenue and gross profit

	Three months ended September 30,		Change 2012 v. 2013	
(dollars in thousands)	**2012**	**2013**	**$**	**%**
Cost of sales revenue	$ 4,723	$ 6,727	$ 2,004	42.4%
Cost of rental revenue	1,926	3,384	1,458	75.7%
Cost of used rental equipment sales	6	24	18	300.0%
Total cost of revenue	6,655	10,135	3,480	52.3%
Gross profit	$ 6,496	$ 9,642	$ 3,146	48.4%
Gross margin %	*49.4%*	*48.8%*		

We manufacture our Inogen One product line in our Goleta, California and Richardson, Texas facilities. Our manufacturing process includes final assembly, testing, and packaging to customer specifications. The increase in cost of sales revenue was attributable to an increase in the number of systems sold, partially offset by reduced bill of material and labor and overhead costs for our products associated with better sourcing and increased volumes. The increase in cost of rental revenue was attributable to an increase of rental patients and related rental assets, depreciation and product exchange and logistics costs. Cost of rental revenue includes depreciation of our rental assets of $4.9 million for the nine months ending September 30, 2013 versus $2.8 million for the nine months ending September 30, 2012.

Table of Contents

Gross margin is defined as revenue less costs of revenue divided by revenue. The overall increase in sales and rental revenue, the increase in sales and rental revenue with respect to our higher margin Inogen One G3, as compared to our Inogen One G2, and the continued shift towards rental revenue in our revenue mix, partially offset by declining rental reimbursement rates, account for the gross margin improvement from 48.7% to 51.8% in the nine months ending September 30, 2012 and 2013, respectively. The rental revenue gross margin was 61.4% in the nine months ended September 30, 2013 versus 63.1% in the nine months ended September 30, 2012 due to lower rental reimbursement rates resulting from round two Competitive Bidding that became effective July 1, 2013, partially offset by lower asset deployment costs per patient and also additional economies of scale of our servicing costs. The sales revenue gross margin was 44.2% in the nine months ended September 30, 2013 versus 37.8% in the nine months ended September 30, 2012 due to the reduction in average cost per unit sold and improved sales revenue mix towards direct-to-consumer sales.

The declining rental reimbursement rates, partially offset by increased revenue, and the continued shift towards rental revenue in our revenue mix, account for the gross margin decreases from 49.4% to 48.8% in the three months ending September 30, 2012 and 2013, respectively. The rental revenue gross margin was 55.7% in the three months ended September 30, 2013 versus 65.9% in the three months ended September 30, 2012 due to lower rental reimbursement rates associated with Competitive Bidding, partially offset by lower asset deployment costs per patient and also additional economies of scale of our servicing costs. The sales revenue gross margin was 43.6% in the three months ended September 30, 2013 versus 35.7% in the three months ended September 30, 2012 due to the reduction in average cost per unit sold and improved sales revenue mix towards direct-to-consumer sales.

Research and development expense

	Nine months ended September 30,		Change 2012 v. 2013	
(dollars in thousands)	**2012**	**2013**	**$**	**%**
Research and development expense	$ 1,731	$ 1,817	$ 86	5.0%

The increase was primarily attributable to an increase in personnel-related expenses of $0.2 million and product development materials and costs of $0.1 million, partially offset by decreasing patent litigation expenses of $0.2 million. Headcount increased due to our Inogen One G3 product launch in 2012 and Inogen At Home product development in 2013. Research and development expenses were $1.8 million, or 3.3% of total revenue, for the nine months ending September 30, 2013 compared to $1.7 million, or 5.0% of total revenue, for the nine months ending September 30, 2012.

General and administrative expense

	Nine months ended September 30,		Change 2012 v. 2013	
(dollars in thousands)	**2012**	**2013**	**$**	**%**
General and administrative expense	$ 5,805	$ 9,796	$ 3,991	68.8%

The increase was primarily attributable to a $1.9 million increase in personnel-related expenses as a result of increased administrative headcount in compliance, billing, human resources, information technology, and finance to support the growth of our business. To accommodate the

Table of Contents

higher headcount in 2013, we incurred higher facility costs of $0.4 million for rent, utilities, property taxes and maintenance. In addition, we incurred $0.2 million of costs associated with this offering.

In addition, bad debt expense increased $0.6 million primarily due to the significant growth of our rental patient population and the increase in aged patient copayment balances in our outstanding accounts receivables. The provision for doubtful accounts, expressed as a percentage of total net revenue, was 2.4% and 2.2% in the nine months ended September 30, 2013 and September 30, 2012, respectively.

General and administrative expenses were $9.8 million, or 17.6% of total revenue, for the nine months ending September 30, 2013 compared to $5.8 million, or 16.7% of total revenue, for the nine months ending September 30, 2012.

Sales and marketing expense

(dollars in thousands)	Nine months ended September 30, 2012	2013	Change 2012 v. 2013 $	%
Sales and marketing expense	$ 8,753	$ 13,292	$ 4,539	51.9%

The increase was primarily attributable to a $3.2 million increase in personnel-related expenses as a result of increased sales and marketing headcount to support the growth of our business, $0.6 million in primarily media-related marketing costs and licensing fees for software and patient support services to continue to grow our rental patient base and consumer cash sales, and a $0.5 million increase in personnel-related expenses for customer service and clinical services to support our increased rental patient base.

Sales and marketing expenses were $13.3 million, or 23.9% of total net revenue for, the nine months ending September 30, 2013 compared to $8.8 million, or 25.2% of total revenue, for the nine months ending September 30, 2012.

Other income (expense), net

(dollars in thousands)	Nine months ended September 30, 2012	2013	Change 2012 v. 2013 $	%
Interest income	$ 84	$ 9	$ (75)	(89.3)%
Interest expense	(381)	(312)	69	18.1%
(Increase) decrease in fair value of preferred stock warrant liability	148	(202)	(350)	(236.5)%
Other income		209	209	N/A
Total other expense, net	$ (149)	$ (296)	$ (147)	(98.7)%

The higher interest income in 2012 was associated with interest accruing on a past due customer balance that was not relevant in 2013. The decrease in interest expense was driven by the decrease in average debt balances under our revolving credit and term loan agreement compared to the prior period. The other income in 2013 was associated with investment income received in connection with the sale of our interest in our former product liability insurance company. This other income is not expected to recur in future periods.

Table of Contents

The increase in preferred stock warrant liability was due to the revaluation of our preferred stock warrants outstanding through a Monte Carlo valuation model due to higher enterprise value and the increased likelihood of an initial public offering.

Comparison of years ended December 31, 2011 and 2012

Revenue

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
Revenue:				
Sales revenue	$ 19,076	$ 28,077	$ 9,001	47.2%
Rental revenue	10,977	19,872	8,895	81.0%
Sales of used equipment	46	95	49	106.5%
Other revenue	535	532	(3)	(0.6)%
Total revenue	$ 30,634	$ 48,576	$ 17,942	58.6%

The increase in sales revenue was attributable to an increase in the number of systems sold, related to an increase in business-to-business sales and an increase in direct-to-consumer sales in the United States and worldwide due to increased sales and marketing efforts and the adoption of portable oxygen concentrators. We experienced a price erosion of 4% in business-to-business sales, which was partially offset by the shift towards direct-to-consumer sales, which experienced a 2% increase in the average selling price. This resulted in a 4% decrease in the average selling price of our products. The increase in rental revenue was related to our increased rental patients from over 7,500 as of December 31, 2011 to over 13,500 as of December 31, 2012 due to additional marketing efforts and increased sales personnel.

Cost of revenue and gross profit

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
Cost of sales revenue	12,127	17,359	5,232	43.1%
Cost of rental revenue	3,783	7,243	3,460	91.5%
Cost of used rental equipment sales	20	25	5	25.0%
Total cost of revenue	$ 15,930	$ 24,627	$ 8,697	54.6%
Gross profit	14,704	23,949	9,245	62.9%
Gross margin %	*48.0%*	*49.3%*		

The increase in cost of revenue was attributable to an increase in the number of systems sold and increased bill of material costs for our products associated with the sales shift to the direct-to-consumer channel where system packages include higher accessories per order. Cost of revenue includes depreciation of our rental assets of $4.1 million for the year ended December 31, 2012 versus $2.4 million for the year ended December 31, 2011.

The continued shift towards rental revenue in our revenue mix, along with the initial launch of our higher margin Inogen One G3 in September 2012, accounted for the gross margin improvement from 48% to 49%. The gross margin on our rental revenue was 64% in the year ended December 31, 2012 versus 66% in the year ended December 31, 2011 due to lower

Table of Contents

reimbursement levels. The gross margin on our sales revenue including sales of used rental equipment was 39% in the year ended December 31, 2012 versus 36% in the year ended December 31, 2011 due to the improved revenue mix towards direct-to-consumer sales.

Research and development expense

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
Research and development expense	$ 1,789	$ 2,262	$ 473	26.4%

The increase was primarily attributable to a $0.1 million increase in personnel related expenses as a result of increased headcount, a $0.3 million increase in patent and patent defense costs, and $0.1 million in additional research and development spend on new product development.

Research and development expenses were $2.3 million, or 4.7% of total net revenue, for the year ending 2012 compared to $1.8 million, or 5.8% of total net revenue, for the year ending 2011.

General and administrative expense

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
General and administrative expense	$ 5,623	$ 8,289	$ 2,666	47.4%

The increase was primarily attributable to a $1.8 million increase in personnel-related expenses as a result of increased administrative headcount in compliance, billing, human resources, information technology, and finance to support the growth of our business and $0.2 million increase in facility costs associated with the leased additional space in Richardson, Texas, and $0.4 million increase in miscellaneous general and administrative costs including telecom costs, postage, supplies, and dues.

In addition, bad debt expense increased $0.06 million due to the growth of our patient population and associated rental revenue bad debt as well as increased bad debt from our business-to-business channel due to a single customer write off. The provision for doubtful accounts, expressed as a percentage of total net revenue, was 2.2% and 3.3% in the year ended December 31, 2012 and December 31, 2011, respectively.

General and administrative expenses were $8.3 million, or 17.1% of total net revenue, for the year ending 2012 compared to $5.6 million, or 18.4% of total net revenue, for the year ending 2011.

Sales and marketing expense

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
Sales and marketing expense	$ 9,014	$ 12,569	$ 3,555	39.4%

The increase was primarily attributable to a $1.7 million increase in personnel-related expenses as a result of increased sales and marketing headcount to support the growth of our business, $0.9 million in primarily media-related marketing costs to continue to grow our rental patient base

Table of Contents

and consumer cash sales, and a $0.5 million increase in personnel-related expenses for customer service and clinical services to support our increased number of rental patients.

Sales and marketing expenses were $12.6 million, or 25.9% of total net revenue, for the year ending 2012 compared to $9.0 million, or 29.4% of total net revenue, for the year ending 2011.

Other income (expense), net

(dollars in thousands)	Year ended December 31, 2011	2012	Change 2011 v. 2012 $	%
Interest income	$ 113	$ 88	$ (25)	(22.1%)
Interest expense	(261)	(493)	(232)	88.9
Revaluation of preferred stock warrant liability	(119)	148	267	(224.4)
Other income (expense)		10	10	
Total other income (expense), net	$ (267)	$ (247)	$ 20	(7.5)%

The increase in interest expense was driven by a $5.3 million increase in borrowings under our revolving credit and term loan agreement. The decrease in interest income was driven by the reduction of interest accruing on past due customer balances as a result of lower past due accounts receivable balances for business-to-business sales in 2012, as compared to 2011.

Liquidity and capital resources

As of September 30, 2013, we had cash and cash equivalents of $17.1 million, which consisted of highly-liquid investments with an original maturity of three months or less. Since inception, we have financed our operations primarily through the sale of equity securities and, to a lesser extent, from borrowings. As of September 30, 2013, we had $12.0 million secured debt outstanding including $11.1 million in bank financing and $0.9 million in patent licensing debt. Since inception, we have received net proceeds of $91.4 million from the issuance of redeemable convertible preferred stock. Our principal uses of cash are funding our capital expenditures including additional rental assets and debt service payments as described below.

We believe that our current cash and cash equivalents together with our short-term investments and available borrowings under our revolving credit and term loan agreement and the cash to be generated from expected product sales and rentals, will be sufficient to meet our projected operating and investing requirements for at least the next 12 months.

The following table shows a summary of our cash flows for the periods indicated:

(dollars in thousands)	Year ended December 31, 2011	2012	Nine months ended September 30, 2012	2013
Cash provided by operating activities	$ 1,859	$ 4,004	$ 2,173	$ 11,478
Cash used in investing activities	(8,918)	(12,475)	(9,101)	(14,497)
Cash provided by financing activities	5,176	19,677	20,120	4,966

Operating activities

We derive operating cash flows from cash collected from the sale of our products and services. These cash flows received are partially offset by our use of cash for operating expenses to

Table of Contents

support the growth of our business. Net income in each period has increased associated with increased sales and gross margin associated with product mix and lower costs. In addition, operating expense leverage has increased as expenses have not grown as quickly as sales due to improved operating efficiencies. The changes in cash related to operating assets and liabilities discussed below were primarily due to the following factors that occurred across all periods: an increase in cash used related to inventory and rental assets as we increased inventory and rental assets to support our growth in revenue; an increase in cash used by accounts receivable resulting from growth in rental receivables which typically have a longer collection cycle; and an increase in cash related to accounts payable resulting from the higher level of operating expenses needed to support the higher sales level.

Net cash provided by operating activities for the nine months ended September 30, 2013 consisted of our net income of $3.5 million and non-cash expense items such as depreciation and amortization of our equipment and leasehold improvements of $6.0 million, provision for doubtful accounts of $1.4 million, loss on disposal of rental units of $0.4 million, loss on change in fair value of warrants of $0.2 million and stock-based compensation of $0.1 million. These items were partially offset by net changes in our operating assets and liabilities of $0.2 million.

Net cash provided by operating activities for the nine months ended September 30, 2012 consisted of our net income of $0.5 million and non-cash expense items such as depreciation and amortization of our equipment and leasehold improvements of $3.5 million, provision for doubtful accounts of $0.7 million, gain on change in fair value of warrants of $0.1 million, and stock-based compensation of $0.05 million. These items were partially offset by net changes in our operating assets and liabilities of $2.6 million.

Net cash provided by operating activities for 2012 consisted of our net income of $0.6 million and non-cash expense items such as depreciation and amortization of our equipment and leasehold improvements of $5.0 million, provision for doubtful accounts of $1.1 million, gain on change in fair value of warrants of $0.2 million, stock-based compensation of $0.1 million. These items were partially offset by net changes in our operating assets and liabilities of $1.4 million.

Net cash provided by operating activities for 2011 consisted of non-cash expense items such as depreciation and amortization of our equipment and leasehold improvements of $3.2 million, provision for doubtful accounts of $1.0 million, stock-based compensation of $0.1 million, loss on change in fair value of warrants of $0.1 million, These items were partially offset by net losses of $2.0 million and net changes in our operating assets and liabilities of $0.9 million.

Investing activities

Net cash used in investing activities for each of the periods presented was primarily for the purchase of rental assets, research and development laboratory, manufacturing and computer equipment and software to support our expanding business.

In the nine months ended September 30, 2013, we invested $11.9 million in rental assets. In the nine months ended September 30, 2012, we invested $7.4 million in rental assets. In 2012, we invested $10.4 million in rental assets deployed. In 2011, we invested $7.9 million in rental assets deployed.

During the year ended December 31, 2011, we acquired Breathe Oxygen Services, LLC mainly to acquire an accredited Medicare facility and a Medicare license to service patients located in

Table of Contents

Tennessee in compliance with applicable law. The acquisition resulted in recording an intangible asset in the amount of $0.1 million which amortizes over its estimated useful life of ten years. As of September 30, 2013, December 31, 2012 and 2011, there were no impairments recorded related to this intangible asset. In 2011, Breathe Oxygen Services, LLC merged with us, and was dissolved.

We expect to continue investing in property and equipment as we expand our operations. Other than the deployment of product for rental to our customers and the necessary manufacturing equipment/tooling for the launch of our next oxygen concentrator in development, we conducted no major capital expenditures during the remainder of 2013. Our operations are inherently capital intensive due to our portions of revenue derived from our rental business model; investments will continue to be required in order to grow rental revenue.

Financing activities

Historically, we have funded our operations through the issuance of preferred stock and the incurrence of indebtedness.

For the nine months ended September 30, 2013, net cash provided by financing activities consisted of $1.9 million received upon exercise of series D convertible preferred stock warrants and common stock options and $6.0 million of new debt issuance under our revolving credit and term loan agreement entered into in October 2012. This was partially offset by repayments of borrowings under our revolving credit and term loan agreement of $2.8 million as existing balances and payback terms were not changed.

For the nine months ended September 30, 2012, net cash provided by financing activities consisted of the issuance of 2,840,260 shares of series G convertible preferred stock for net proceeds of $19.9 million in March 2012, the incurrence of an aggregate of $2.0 million of borrowings under our revolving credit and term loan agreement, which were offset in part by repayment of $1.9 million of such borrowings, and the exercise of series B convertible and series C convertible preferred stock warrants for $0.2 million.

For 2012, net cash provided by financing activities consisted of the issuance of 2,840,260 shares of series G convertible preferred stock which generated net proceeds of $19.9 million in March 2012, the incurrence of an aggregate of $6.0 million of borrowings under our revolving credit and term loan agreement, which were offset in part by repayment of $6.5 million of such borrowings, and the exercise of series B convertible and series C convertible preferred stock warrants for $0.4 million.

For 2011, net cash provided by financing activities consisted of net incurrence of indebtedness under our revolving credit and term loan agreement of $5.3 million.

Accounts receivable

Accounts receivable before allowance for doubtful accounts, rental adjustments and sales returns increased $4.5 million, or 49%, from $9.1 million at December 31, 2012 to $13.6 million at September 30, 2013. Revenues for the three month periods ending December 31, 2012 and September 30, 2013 were $13.8 million and $19.8 million, respectively, which is an increase of $5.9 million and 43%. The increase in accounts receivable was primarily attributable to an increase in sales as well as an increase in the aging of our rental receivables.

Table of Contents

Included in accounts receivable are earned but unbilled receivables of $1.0 million at December 31, 2012 and $1.2 million at September 30, 2013. Delays, ranging from a day to several weeks between the date of service, and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from the date of service and are considered in our analysis of historical performance and collectability.

Due to the nature of the industry and the reimbursement environment in which we operate, certain estimates are required to record net revenue and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for services from some payors may result in adjustments to amounts originally recorded. These adjustments are typically identified and recorded at the point of cash application, claim denial or account review.

Management performs analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Because of continuing changes in the healthcare industry and third-party reimbursement, it is possible that management s estimates could change, which could have an impact on operations and cash flows.

We derive a significant portion of our rental revenue from Medicare. Revenue is recognized at net realizable amounts estimated to be paid by payors and patients. Our billing system contains payor-specific price tables that reflect the fee schedule amounts in effect or contractually agreed upon by various government and commercial payors for each item of equipment or supply provided to a customer. For Medicare and Medicaid revenues, as well as most other third-party payors, final payment is subject to administrative review and audit. We make estimated provisions for adjustments, including adjustments from administrative review and audit, based on historical experience. We closely monitor our historical collection rates as well as changes in applicable laws, rules and regulations and contract terms in an attempt to use the most accurate information available in determining these provisions. However, due to the complexities involved in these estimates, actual payments we receive could be different from the amounts we estimate and record.

Collection of receivables from third-party payors and patients is a significant source of cash and is critical to our operating performance. Our primary collection risks relate to patient accounts for which the primary insurance payor has paid, but patient responsibility amounts (generally deductibles and co-payments) remain outstanding. We record bad debt expense based on a percentage of revenue using historical data specific to us. The percentage and amounts used to record bad debt expense and the allowance for doubtful accounts are supported by various methods including current and historical cash collections, bad debt write-offs and aging of accounts receivable. We write off accounts receivable against the allowance when all collection efforts (including payor appeals processes) have been exhausted. We routinely review accounts receivable balances in conjunction with our historical contractual adjustments and bad debt rates and other economic conditions that might ultimately affect the collectability of patient accounts when we consider the adequacy of the amounts we record as provision for doubtful accounts. Prior to 2014, we managed our billing and collection of accounts receivable through our own staff.

Table of Contents

Accounts receivable balance concentrations by major category as of December 31, 2012 and September 30, 2013 were as follows:

	December 31, 2012	September 30, 2013
Percentage of Accounts Receivable Outstanding:		
Medicare	39%	24%
Medicaid/Other Government	3%	4%
Private Insurance	21%	27%
Patient Responsibility	18%	23%
Business to Business Sales	19%	22%
Total	100.0%	100.0%

The following table sets forth the percentage breakdown of our accounts receivable by aging category as of December 31, 2012 and September 30, 2013.

	December 31, 2012	September 30, 2013
Accounts receivable by aging category:		
Unbilled	11%	9%
Aged 0-90 days	63%	57%
Aged 91-180 days	12%	12%
Aged 181-365 days	12%	14%
Aged over 365 days	2%	8%
Total	100%	100%

The following table sets forth the percentage breakdown of our allowances to accounts receivable as of December 31, 2012 and September 30, 2013.

	December 31, 2012	September 30, 2013
Percentage of Allowance to Accounts Receivable:		
Bad Debt Reserve	8%	14%
Rental Adjustments & Write-Offs Reserve	14%	14%
Direct to Consumer Sales Returns Reserve	1%	1%
Total Percentage of Allowance to Accounts Receivable	23%	29%

The increase in total percentage of our allowances to accounts receivable from 23% as of December 31, 2012 to 29% as of September 30, 2013 was primarily related to our rental business and patient co-pay balances. These balances aged over 365 days have increased from 2% to 8% in the periods presented. We believe our reserves are adequate and properly present the collectability of our outstanding accounts receivable balances based on our analysis of these balances. We review the accounts receivables on at least a quarterly basis to assess the allowance for doubtful accounts. In general, our allowance for doubtful accounts is higher for our rental revenue compared to our sales revenue. Due to our

growth in our rental patient base in the relevant periods, as well as approximately 30% annualized turnover in our billing and collections team, our write-offs and past due rental accounts receivable balances have increased. In order to

Table of Contents

achieve higher collectability rates on the aging patient balances, we have engaged a third party collection agency which will focus collection efforts on these balances starting in 2014.

The ultimate collection of accounts receivable may not be known for several months because the third party collection firm will not start collection efforts until 2014. We record bad debt expense based on a percentage of revenue using historical data specific to us. The percentage and amounts used to record bad debt expense and the allowance for doubtful accounts are supported by various methods and analyses, including current and historical cash collections, bad debt write-offs, aged accounts receivable and consideration of any payor-specific concerns. The ultimate write-off of an accounts receivable occurs once collection is considered to be unlikely.

We do not use an aging threshold for account receivable write-offs. However, the age of an account balance may provide an indication that collection procedures have been exhausted, and would be considered in the review and approval of an account balance write-off.

Sources of funds

Our cash provided in operations in the nine months ended September 30, 2013 was $11.5 million compared to $2.2 million in the nine months ended September 30, 2012. As of September 30, 2013 we had cash and cash equivalents of $17.1 million and available borrowing capacity under our revolving credit and term loan agreement totaling $6.0 million.

We believe, based on our current operating plan, that our existing cash and cash equivalents, cash generated from operating activities and available borrowings under our borrowing arrangements will be sufficient to fund capital expenditures, operating expenses and other cash requirements for at least the next 12 months. Although we are not currently a party to any agreement or letter of intent with respect to potential material investments in, or acquisitions of, complementary businesses, we may enter into these types of arrangements in the future, which could require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us, or at all.

Amended and restated revolving credit and term loan agreement

In October 2012, we entered into an amended and restated revolving credit and term loan agreement with Comerica Bank as the administrative agent, which we refer to as our revolving credit and term loan agreement. This agreement incorporated amounts outstanding under one prior loan agreement whereby the existing balances and the payback terms were not changed. This transaction did not result in any debt extinguishment losses or gains. We did not incur or defer any financing cost directly related to the amended loan and security agreement.

The revolving credit and term loan agreement also provides for a pre-existing term loan facility for rental assets amounting to up to $3.0 million, which we refer to as Term Loan A, a pre-existing term loan facility for rental assets amounting to up to $8.0 million, which we refer to as Term Loan B, a new term loan facility for rental assets amounting to up to $12.0 million, which we refer to as Term Loan C, and an accounts receivable revolving line of credit amounting to up to $1.0 million based on 80% of eligible accounts receivable, which we refer to as the revolver.

We had borrowings of $1.4 million, $2.3 million and $0.7 million outstanding under Term Loan A as of December 31, 2012 and 2011 and September 30, 2013, respectively. We had borrowings of $6.4 million, $6.0 million and $4.4 million outstanding under Term Loan B, as of December 31,

Table of Contents

2012 and 2011 and September 30, 2013, respectively. There were no borrowings and borrowings of $6.0 million outstanding under Term Loan C as of December 31, 2012 and September 30, 2013, respectively. Future draws under Term Loan C will bear variable interest at the Base Rate. There were no borrowings under the revolver during 2011, 2012, or as of September 30, 2013. The revolver expired on October 13, 2013 and we have no plans to renew or replace it.

Payments of interest for the Term Loan are generally payable monthly. Payment of principal is payable monthly. Each term loan bears interest at the base rate, which is a rate equal to the applicable margin plus the greater of (i) the prime rate, (ii) the federal funds effective rate, as defined in the agreement, plus 1%, and (iii) the daily adjusting LIBOR rate, plus 1%. The applicable margins for Term Loans A, B and C are 1.25%, 2.50% and 2.25%, respectively. Upon the closing of an acquisition or initial public offering during the term of the revolving credit and term loan agreement, the lenders are entitled to a fee equal to $120,000.

The revolving credit and term loan agreement contains customary conditions to borrowing, events of default and covenants, including covenants that restrict our ability to dispose of assets, merge with or acquire other entities, incur indebtedness, incur encumbrances, make distributions to holders of our capital stock, make investments, engage in transactions with our affiliates. In addition, we must comply with certain financial covenants relating to liquidity, debt service, and leverage ratios. We were in compliance with all covenants as of December 31, 2012 and September 30, 2013. As of September 30, 2013, in order to be in compliance with the liquidity requirements, debt service ratios, and leverage ratios of existing debt obligations, we were required to maintain $2.5 million of unaudited Adjusted EBITDA in the previous six months, and we had $6.6 million in actual unaudited Adjusted EBITDA, and $7.8 million of cash and qualified accounts receivable, and we had $17.1 million of actual cash. Our obligations under the revolving credit and term loan agreement are secured by substantially all of our assets, including intellectual property.

We may from time to time, depending upon market conditions and financing needs, seek to refinance or repurchase our debt securities or loans in privately negotiated or open market transactions, by tender offer or otherwise.

Use of funds

Our principal uses of cash are funding our new rental asset deployments and other capital purchases, operations, satisfaction of our obligations under our debt instruments, and other working capital requirements. Over the past several years, our revenue has increased significantly from year to year and, as a result, our cash flows from customer collections have increased as have our profits. As a result, our cash used in operating activities has decreased over time and now is a source of capital to the business. We expect operating activities to continue to be a source of capital to the business in the future.

Due to the portion of our business that drives rental revenue, which needs continuing asset deployments to new patients, our cash used in investing activities has increased over time. We expect our investment cash requirements to increase in the future as we increase our rental patient base and deploy rental assets among Medicare and private payors.

We may need to raise additional funds to support our investing operations, and such funding may not be available to us on acceptable terms, or at all. If we are unable to raise additional funds when needed, our operations and ability to execute our business strategy could be adversely affected. We may seek to raise additional funds through equity, equity-linked or debt

Table of Contents

financings. If we raise additional funds through the incurrence of indebtedness, such indebtedness would have rights that are senior to holders of our equity securities and could contain covenants that restrict our operations. Any additional equity financing may be dilutive to our stockholders.

Contractual obligations

The following table reflects a summary of our contractual obligations as of December 31, 2012.

		Payments due by period			
Contractual obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
(in thousands)					
Operating lease obligations(1)	$ 3,605	$ 788	$ 1,864	$ 329	$ 624
Long-term debt obligations(2)(3)	8,936	3,879	5,057		
Total	$ 12,541	$ 4,667	$ 6,921	$ 329	$ 624

(1) Operating lease costs are primarily for office and manufacturing space.

(2) Includes principal and accrued interest on long-term debt obligations.

(3) In 2011, we entered into an amendment of a licensing agreement whereby we were assigned the entire right, title and interest in a portfolio of patents in exchange for a non-interest bearing promissory note for $650,000, in addition to an $850,000 existing obligation to the original licensor, for a total of $1.5 million due to the original licensor in installments starting May 22, 2011, and ending October 31, 2016.

Critical accounting policies and significant estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosure of contingent assets and liabilities, revenue and expenses at the date of the financial statements. Generally, we base our estimates on historical experience and on various other assumptions in accordance with GAAP that we believe to be reasonable under the circumstances. Actual results may differ from these estimates and such differences could be material to the financial position and results of operations.

Critical accounting policies and estimates are those that we consider the most important to the portrayal of our financial condition and results of operations because they require our most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Our critical accounting policies and estimates include those related to:

- revenue recognition;
- stock-based compensation;
- inventory and rental asset valuation;
- accounts receivables and allowance for bad debts, returns and adjustments;
- fair value measurements; and
- income taxes.

Revenue recognition

We generate revenue primarily from sales and rentals of our products. Our products consist of our proprietary line of portable oxygen concentrators and related accessories. A small portion of our revenue comes from extended service contracts and freight revenue for product shipments.

Table of Contents

Revenue from product sales is recognized when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the price to the customer is fixed or determinable; and (4) collectability is reasonable assured. Revenue from product sales is recognized upon shipment of the product. Provisions for estimated returns and discounts are made at the time of shipment. Provisions for warranty obligations, which are included in cost of sales revenue, are also provided for at the time of shipment.

Accruals for estimated warranty expenses are made at the time that the associated revenue is recognized. We use judgment to estimate these accruals and, if we were to experience an increase in warranty claims or if costs of servicing our products under warranty were greater than our estimates, our cost of revenue could be adversely affected in future periods. The provisions for estimated returns, discounts and warranty obligations are made based on known claims and discount commitments and estimates of additional returns and warranty obligations based on historical data and future expectations. We accrued $0.4 million and $0.3 million to provide for future warranty costs at December 31, 2012 and 2011, respectively.

We recognize equipment rental revenue over the non-cancelable lease term, which is one month, less estimated adjustments, per ASC 840 Leases. We have separate contracts with each patient that are not subject to a master lease agreement with any payor. We evaluate the individual lease contracts at lease inception and the start of each monthly renewal period to determine if there is reasonable assurance that the bargain renewal option associated with the potential capped free rental period would be exercised. Historically, the exercise of such bargain renewal option is not reasonably assured at lease inception and most subsequent monthly lease renewal periods. If we determine that the reasonable assurance threshold for an individual patient is met at lease inception or at a monthly lease renewal period, such determination would impact the bargain renewal period for an individual lease. We would first consider the lease classification issue (sales-type lease or operating lease) and then appropriately recognize or defer rental revenue over the lease term, which may include a portion of the capped rental period. To date, we have not deferred any amounts associated with the capped rental period. Amounts related to the capped rental period have not been material in the periods presented.

The lease term begins on the date products are shipped to patients and are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including Medicare, private payors, and Medicaid. Due to the nature of the industry and the reimbursement environment in which we operate, certain estimates are required to record net revenue and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review. Accounts receivable are reduced by an allowance for doubtful accounts which provides for those accounts from which payment is not expected to be received, although product was delivered and revenue was earned. Upon determination that an account is uncollectible, it is written-off and charged to the allowance. Amounts billed but not earned due to the timing of the billing cycle are deferred and recognized in income on a straight-line basis over the monthly billing period. For example, if the first day of the billing period does not fall on the first of the month, then a portion of the monthly billing period will fall in the subsequent month and the related revenue and cost would be deferred based on the service days in the following month.

Table of Contents

Rental revenue is recognized as earned, less estimated adjustments. Revenue not billed at the end of the period is reviewed for the likelihood of collections and accrued. The rental revenue stream is not guaranteed and payment will cease if the patient no longer needs oxygen or returns the equipment. Revenue recognized is at full estimated allowable; transfers to secondary insurances / patient responsibility have no net effect on revenue. Rental revenue is earned for that month if the patient is on service on the first day of the 30-day period commencing on the recurring date of service for a particular claim, regardless if there is a change in condition/death after that date. There is no refund for revenue collected in the 3 year period if the patient does not reach the end of the 5 year capped period. In the event that a third-party payor does not accept the claim for payment, the consumer is ultimately responsible for payment for the products and services. We have determined that the balances are collectable at the time of revenue recognition because the patient signs a notice of financial responsibility outlining their obligations.

Included in rental revenue are unbilled amounts that were earned but not able to be billed for various reasons. The criteria for recognizing revenue had been met as of period-end, but there were specific reasons why we were unable to bill Medicare and private insurance for these amounts. As a result, we create an unbilled rental revenue accrual based on these earned revenues not billed based on a percentage of unbilled amounts and historical trends and estimates of future collectability.

Revenue from the sale of used rental equipment is recognized upon delivery and when collectability is reasonably assured and other revenue recognition criteria are met. When a rental unit is sold, the related cost and accumulated depreciation are removed from their respective accounts, and any gains or losses are included in gross profit.

Revenue from the sales of our services is recognized when no significant obligations remain undelivered and collection of the receivables is reasonably assured, which is generally when shipment has occurred. We offer extended service contracts on our Inogen One systems for periods ranging from 12 to 24 months after the end of the standard warranty period. Revenue from extended service contracts and lifetime warranty is deferred and recognized in income over the contract period. To calculate the value associated with the lifetime warranties, management considered the profit margins of the overall company, the average cost of lifetime warranties and the price of extended warranties and created a best estimate. Lifetime warranty revenue is deferred and recognized after the standard three year warranty period, on straight-line basis, in year four and five. Under the lifetime warranty, the company will provide replacement equipment without any additional cost to the consumer for the duration of the patient s life. Lifetime warranties are non-transferable.

Stock-based compensation

We measure and recognize compensation expense for the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The fair value of options on the grant date is estimated using the Black-Scholes option-pricing model, which requires the use of certain subjective assumptions including expected term, volatility, risk-free interest rate and the fair value of our common stock. These assumptions generally require significant judgment.

Table of Contents

The resulting costs, net of estimated forfeitures, are recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. We amortize the fair value of stock-based compensation on a straight-line basis over the requisite service periods.

Currently, our equity awards consist only of stock options. However, in the future we may grant shares of restricted stock and restricted stock units under the terms of our equity incentive plans. We account for stock options issued to nonemployees at their estimated fair value determined using the Black-Scholes option-pricing model. The fair value of the options granted to nonemployees is re-measured as they vest, and the resulting change in value, if any, is recognized as a stock-based compensation expense during the period the related services are rendered. In the years ending December 31, 2011 and 2012 and the nine-month periods ending September 30, 2012 and 2013, we did not issue stock options to any non-employees and all previous stock options issued to non-employees were fully vested in previous periods.

The Black-Scholes option-pricing model requires the input of highly subjective assumptions, including the expected volatility of the price of our common stock, the expected term of the option, the expected dividend yield, and the risk-free interest rate. These estimates involve inherent uncertainties and the significant application of management s judgment. If factors change and different assumptions are used, our stock-based compensation expense could be materially different in the future. We determined weighted average valuation assumptions as follows:

Risk free rate. The risk free interest rate is based on the yields of U.S. Treasury securities with maturities similar to the expected term of the options for each option group.

Expected term. Using the simplified method, the expected term is estimated as the midpoint of the expected time to vest and the contractual term, as permitted by the SEC. For out of the money option grants, we estimate the expected lives based on the midpoint of the expected time to a liquidity event and the contractual term.

Dividend yield. We have never declared or paid any cash dividends and do not presently plan to pay cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero.

Volatility. Our expected volatility is derived from the historical volatilities of several unrelated public companies in the medical manufacturing and healthcare service industries because we have little information on the volatility of the price of our common stock because we have no trading history. When making the selections of our industry peer companies to be used in the volatility calculation, we consider operational area, size, business model, industry and the business of potential comparable companies. These historical volatilities are weighted based on certain qualitative factors and combined to produce a single volatility factor.

The following table summarizes the assumptions relating to our stock options for the years ended December 31, 2011 and 2012 and the nine-month periods ended September 30, 2012 and 2013:

	Year ended December 31,		Nine months ended September 30,	
	2011	2012	2012	2013
Risk-free interest rates	1.18%-2.71%	0.73%-1.33%	0.92%-3.04%	0.73%-2.89%
Expected term	5.91-6.08 years	5.51-6.07 years	5.18-6.16 years	5.51-6.08 years
Expected dividend yield	0%	0%	0%	0%
Volatility	47.76-48.55%	48.95-50.52%	44.62-49.96%	46.58-50.52%

Table of Contents

If in the future we determine that another method is more reasonable, or if another method for calculating these input assumptions is prescribed by authoritative guidance, and, therefore, should be used to estimate volatility or expected life, the fair value calculated for our stock options could change significantly. Higher volatility and longer expected lives result in an increase to stock-based compensation expense determined at the date of grant. Stock-based compensation expense affects our cost of revenue, research and development expense, and selling, general and administrative expense.

We estimate our forfeiture rate based on an analysis of our actual forfeitures and will continue to evaluate the appropriateness of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover behavior and other factors. Quarterly changes in the estimated forfeiture rate can have a significant effect on reported stock-based compensation expense, as the cumulative effect of adjusting the rate for all expense amortization is recognized in the period the forfeiture estimate is changed. If a revised forfeiture rate is higher than the previously estimated forfeiture rate, an adjustment is made that will result in a decrease to the stock-based compensation expense recognized in the financial statements. If a revised forfeiture rate is lower than the previously estimated forfeiture rate, an adjustment is made that will result in an increase to the stock-based compensation expense recognized in the financial statements. The effect of forfeiture adjustments was insignificant for the years ended December 31, 2011 and 2012 and the nine-month periods ended September 30, 2012 and 2013. We will continue to use significant judgment in evaluating the expected term, volatility and forfeiture rate related to our stock-based compensation.

We recorded stock-based compensation of $144,000 and $60,000 for the years ended December 31, 2011 and 2012, respectively, and $48,000 and $116,000 for the nine-month periods ended September 30, 2012 and 2013, respectively. As of September 30, 2013, we had $0.5 million of unrecognized stock-based compensation costs, which are expected to be recognized over an average period of four years. In future periods, we expect stock-based compensation to increase due in part to our existing unrecognized stock-based compensation and as we issue additional stock-based awards to continue to attract and retain employees.

Common stock valuation

It is also necessary to estimate the fair value of the common stock underlying our equity awards when computing the fair value calculation of options under the Black-Scholes option-pricing model. The fair value of the common stock underlying our equity awards was assessed on each grant date by our board of directors. Given the absence of an active market for our common stock prior to this offering, our board of directors determined the estimated fair value of our common stock based on an analysis of a number of objective and subjective factors that we believe market participants would consider, including the following:

- our results of operations, history of losses and other financial metrics;
- our capital resources and financial condition;
- the contemporaneous valuations of our common stock by Timan, LLC, an unrelated third-party valuation firm;
- the prices of our convertible redeemable preferred stock sold to outside investors in arms-length transactions;
- the rights, preferences and privileges of our convertible preferred stock relative to those of our common stock;

Table of Contents

the rights of freestanding warrants and other similar instruments related to our securities that are redeemable;

the hiring of key personnel;

the introduction of new products;

the fact that the option grants involve illiquid securities in a private company;

the risks inherent in the development and expansion of our products and services; and

the likelihood of achieving a liquidity event, such as an initial public offering or sale of our company given prevailing market conditions.

We have historically granted stock options with exercise prices no less than the fair value of our common stock underlying the stock options, as determined at the date of grant by our board of directors, with input from our management and Timan, LLC, an independent third party valuation expert. The following table summarizes, by grant date, the number of stock options granted since January 1, 2012 and the associated per share exercise price:

Grant date	Common shares underlying options granted	Exercise price per share	Fair value per common share as determined by the board of directors at grant date	Fair value per common share for financial reporting purposes at grant date	Intrinsic value per underlying common share
March 28, 2012	209,967	$ 0.81	$ 0.81	$ 0.81	$ 0.00
June 6, 2012	10,122	0.81	0.81	0.81	0.00
September 18, 2012	8,403	0.81	0.81	0.81	0.00
December 7, 2012	20,104	0.81	0.81	0.81	0.00
February 12, 2013	376,660	1.17	1.17	1.17	0.00
May 14, 2013	63,333	1.17	1.17	6.24	5.07
October 11, 2013	276,334	8.37	8.37	8.37	0.00

Our board of directors intended that all options granted be exercisable at a price per share not less than the per share fair market value of our common stock underlying those options on the date of grant. The following is a discussion of all options we have granted since January 1, 2012 and the significant factors contributing to our board of director s determination of the fair value:

March 28, 2012, June 6, 2012, September 18, 2012, and December 7, 2012 Options granted on these dates had an exercise price of $0.81 per share, which was equal to the fair value of our common stock as determined by our board of directors on each grant date. In anticipation of the March grants, our board of directors obtained a third-party valuation of our common stock in December 2011 and March 2012, described in more detail below, both of which assumed a $20.0 million financing event and suggested a fair value of $0.81 per share. Our board of directors considered these valuations together with the other objective and subjective factors described above in reaching its determination of the fair value of our common stock as of March 2012. In particular, our board of directors considered the price of its most recent round of financing, which occurred in March 2012 and involved the sale and issuance of an additional $20.0 million in Series G convertible preferred

stock; the other rights, privileges and preferences associated with our convertible preferred stock relative to the common stock; the general financial condition of the business and its capital resources at that time; and the risks and

uncertainties associated with further development and expansion of our products. For each of the grant dates subsequent to March 2012 through December 2012, our board of directors again considered the March 2012 third-party valuation together with additional changes that may have occurred within the business since March 2012. At each grant date, our board of directors considered the impact of the rights, privileges and preferences of our outstanding shares of convertible preferred stock, the continued illiquidity of our common stock given our status as a private company, the ongoing risks associated with further development of the company and generally low likelihood of a liquidity event, such as an initial public offering or a sale of the company, occurring during 2012. Our board of directors also noted the initial launch of the Inogen One G3 in September 2012, but given the limited nature of the launch and the inability to predict its impact on the business at that time our board of directors determined this did not constitute a significant change in the business. In particular, our board of directors considered that in December 2011 we decided to raise an additional $20.0 million in financing through the sale and issuance of our series G convertible preferred stock, the proceeds of which were used to continue to invest the business operations, in particular the capital intensive rental business. This financing closed on March 12, 2012 and was critical to the success of growing our revenue to $48.6 million in 2012. The amount of the financing was determined based on the projections of capital necessary to achieve our goal of exceeding $100 million of sales in order to pursue a sale of the company or an initial public offering following the achievement of this goal. It was estimated that we would achieve this goal within a minimum of three years. Based on these considerations, our board of directors determined that no significant change in our business or expectations of future business had occurred as of each grant date since the March 31, 2012 valuation that would have warranted a materially different determination of the value of our common stock than that suggested by the board of directors original determination in March 2012 and the corresponding contemporaneous independent third-party valuation.

February 12, 2013 Options granted on this date had an exercise price of $1.17 per share, which was equal to the fair value of our common stock as determined by our board of directors on that date. In reaching this determination, our board of directors considered each of the objective and subjective factors described above, including our most recent independent third party valuation, described in more detail below, which suggested a fair value of our common stock of $1.17 per share as of December 31, 2012. In addition to the third-party valuation, our board of directors considered that in December 2012 the Inogen One G3 product manufacturing was at full capacity and that we had shown year-over-year improvement in our financial results due to the strength of our business to business and direct-to-consumer sales. However, the board of directors also noted that, while financial results had improved, they were still in line with expectations set in December 2011. The board of directors also considered the likelihood of a liquidity event. We had engaged an investment banking firm to consider a sale of the company, which increased this likelihood from 40% to 65% as that investment banking firm was not pursuing an initial public offering due to the board s direction and the firm s expertise being primarily in mergers and acquisitions. Due to our continued growth, the likelihood of an initial public offering had increased from 5% to 10% as well, although no immediate plans were made to pursue an initial public offering. Based on these considerations, our board of directors determined that no significant change in our business, financial results and trends, expected probabilities of various exit scenarios, or expectations of future business had occurred between the December 31, 2012 unrelated third-party valuation and the February 12, 2013 grant date that would have warranted a materially different determination of the value of our common stock than that suggested by the valuation, so as a result a new valuation was not performed. We believe that a retrospective

Table of Contents

valuation of our common shares as of February 12, 2013 would not result in a different value from the December 31, 2012 valuation previously performed and thus determined a new valuation was not necessary. The valuation approach used for December 31, 2012 was the Option-Pricing Method, which we and the valuation specialist determined to be the appropriate valuation method due to the low probability of an initial public offering at the time and our stage of development.

May 14, 2013 Options granted on this date had an exercise price of $1.17 per share, which was equal to the fair value of our common stock as determined by our board of directors on that date. In reaching this determination, our board of directors considered each of the objective and subjective factors described above, including the most recent unrelated third-party valuation of our common stock as of December 31, 2012. Based on these considerations, our board of directors determined that no significant change in our business or expectations of future business had occurred between the December 31, 2012 independent third-party valuation and the May 14, 2013 grant date that would have warranted a materially different determination of the fair value of our common stock than that suggested by the valuation.

In preparing for this offering, we determined that a retrospective valuation of the fair value of our common stock as of May 14, 2013 was appropriate for accounting purposes. In assessing the retrospective value of the common stock, our board of directors considered the unrelated-third party valuation it received as of July 31, 2013, described in more detail below, which suggested a fair market value at that date of $6.24 per share. Our board of directors noted that the primary drivers for increased value in the July 2013 third-party valuation were largely associated with increases in the likelihood of a potential liquidity event. Our board of directors determined that the likelihood of a strategic sale decreased and the likelihood of an initial public offering increased due to the fact that the initial public offering market was now accessible to companies with less than $100 million in sales, the valuations for similarly situated companies were increasing, and the JOBS Act was successfully allowing for a more streamlined initial public offering process. In addition, our board of directors noted that it had ended our relationship with the investment banking firm engaged in the fourth quarter of 2012 to sell the company and had engaged its current investment banking firm in May 2013 primarily to consider an initial public offering as the sales efforts undertaken with the assistance of the prior investment banking firm had not produced a strategic or financial investor that met our board of director s expectations. Management estimated that the probability of an initial public offering within 180 days was 40%. In July 2013, we held our organizational meeting in connection with this offering. As a result of these factors, the independent third-party valuation performed in July 2013 indicated a fair value of our common stock of $6.24 per share. Based on this analysis, our board of directors determined that for accounting purposes the retrospective fair value of our common stock on May 14, 2013 was $6.24 per share.

October 11, 2013. Options granted on this date had an exercise price of $8.37 per share, which was equal to the fair value of our common stock as determined by our board of directors on that date. In reaching this determination, our board of directors considered each of the objective and subjective factors described above. Our board of directors also considered that sales and profits continued to grow in 2013 in line with our expectations. Our board of directors also considered the most recent independent third party valuation of our common stock as of September 30, 2013, described in detail below, which suggested a fair value of $8.37 per share. In addition to third-party valuation, our board of directors noted that over the past 12 months, we had consistently added new customers and improved efficiencies in operations, such that our revenue

had grown as had our overall profits. This growth was experienced across the entire company, including rental, direct-to-consumer and business-to-business sales channels. Moreover, revenue growth and profits had slightly exceeded expectations. In addition, management estimated that the probability of an initial public offering within 180 days was 60%. Based on these considerations, our board of directors determined that the fair value of our common stock as of October 11, 2013 was $8.37 per share.

Contemporaneous independent third-party valuations

The independent third-party valuations described below were prepared by Timan, LLC using methodologies, approaches and assumptions consistent with the American Institute of Certified Public Accountants, or AICPA, Audit and Accounting Practice Aid Series: *Valuation of Privately Held Company Equity Securities Issued as Compensation,* or the AICPA Practice Guide. At the March 31, 2012 and December 31, 2012 valuation dates described below, we used the income approach to estimate our aggregate enterprise value. The income approach measures the value of a company as the present value of its future economic benefits by applying an appropriate risk-adjusted discount rate to expected cash flows, based on forecasted revenue and costs. We prepared a financial forecast for each valuation date to be used in the computation of the enterprise value for the income approach. The financial forecasts took into account our past experience and future expectations. The risks associated with achieving these forecasts were assessed in selecting the appropriate discount rate. There is inherent uncertainty in these estimates.

In order to arrive at the estimated fair value of our common stock, the indicated enterprise value of our company calculated at each valuation date using the income approach was allocated to the shares of convertible redeemable preferred stock and the warrants to purchase these shares, and shares of common stock and the options to purchase these shares using a Black Scholes option-pricing model. The Black-Scholes option-pricing model treats common stock and preferred stock as call options on the total equity value of a company, with exercise prices based on the value thresholds at which the allocation among the various holders of a company s securities changes. Under the Black-Scholes option-pricing model, the common stock has value only if the funds available for distribution to stockholders exceed the value of the liquidation preference at the time of a liquidity event, such as a strategic sale, merger or initial public offering, assuming the enterprise has funds available to make a liquidation preference meaningful and collectable by the holders of preferred stock. The common stock is modeled as a call option on the underlying equity value at a predetermined exercise price. In the model, the exercise price is based on a comparison with the total equity value rather than, as in the case of a regular call option, a comparison with a per share stock price. Thus, common stock is considered to be a call option with a claim on the enterprise at an exercise price equal to the remaining value immediately after the preferred stock is liquidated. The Black-Scholes option-pricing model is then used to price the options. This model defines the securities fair values as functions of the current fair value of a company and uses assumptions such as the anticipated timing of a potential liquidity event, marketability, cost of capital and the estimated volatility of the equity securities. The anticipated timing of a liquidity event utilized in these valuations was based on then-current plans and estimates of our board of directors and management regarding a liquidity event. Estimates of the volatility of our stock were based on available information on the volatility of capital stock of comparable publicly-traded companies. In addition, the valuation considers the fact that our stockholders cannot freely trade our common stock in the public markets. Therefore, the estimated fair value of our common stock at each grant date reflects a non-marketability discount.

Table of Contents

December 31, 2011 and March 31, 2012 common stock valuation analyses

Our December 2011 and March 2012 unrelated third-party valuations used a Black-Scholes option pricing model to allocate our estimated enterprise value to the common stock. The valuations applied a risk-adjusted discount of 30%, a non-marketability discount of 15%, and an estimated time to a liquidity event of 3 years. The risk-adjusted discount was estimated to be 30% due to the assumption is that we were in the Bridge / IPO stage of development per AICPA valuation methodologies since we have product revenue and achieved positive EBITDA in 2012. Based on these considerations, the independent third-party valuations suggested that the fair market value of our common stock was $0.81 per share as of December 31, 2011 and March 31, 2012.

December 31, 2012 common stock valuation analysis

Our December 2012 independent third-party valuation analysis also used a Black-Scholes option pricing model to allocate our estimated enterprise value to the common stock. The analysis applied a risk-adjusted discount of 30%, a non-marketability discount of 15%, and an estimated time to a liquidity event of 1 to 3 years, with a weighted average time to exit estimated at 1.9 years. The risk-adjusted discount was estimated to be 30% due to the assumption is that we were in the Bridge / IPO stage of development per AICPA valuation methodologies since we have product revenue and achieved positive EBITDA in 2012. Based on these considerations, the third-party valuation suggested that the fair market value of our common stock was $1.17 per share as of December 31, 2012.

July 31, 2013 and September 30, 2013 common stock valuation analyses

Due to our decision to pursue this offering, along with our belief that we could reasonably estimate the form and timing of potential liquidity events, independent probability weighted expected return method, or PWERM, to allocate our estimated enterprise value to our common stock for purposes of our July 31, 2013 and September 30, 2013 common stock valuations. The values derived under the income or discounted cash flow approach were first used to determine an initial estimated enterprise value. The initial estimated enterprise value was then subjected to the PWERM model which produced the per share value utilizing a probability-weighted scenarios analysis. The following scenarios were assumed:

Initial public offering. Estimates the value based on an estimated initial public offering, or IPO, value discounted to the present value based on both risk and timing.

Sale of the company. Estimates the value assuming the sale of the entire enterprise, based on estimates of future value in a potential sale transaction discounted to the present value.

Private company. Uses both the market comparable approach and the income approach to estimate the equity value as of the valuation date, and then allocates that value using the option pricing model, assuming that the company remains private for longer than in either of the previous scenarios.

Liquidation. Assumes we are dissolved, in which case the book value less the applicable liquidation preferences represents the amount available to the holders of common stock.

Over time, as we achieve certain milestones, the probabilities, likely exit values in an initial public offering and sale of the company scenarios, and current value in the private company scenario are adjusted accordingly, with the probability of a successful exit such as an initial public offering or sale of the company increasing over time.

Table of Contents

The July 2013 independent third-party valuation used a risk-adjusted discount of 30%, a non-marketability discount of 12-16%, and an estimated time to liquidity event of 0.5 years to 3.0 years, with a weighted average time to exit estimated at 0.71 years. The risk-adjusted discount was estimated to be 30% due to the assumption that we were in the Bridge / IPO stage of development per AICPA valuation methodologies since we have product revenue and achieved positive EBITDA in 2012. The unrelated third-party valuation analysis used the following probability weighted scenarios:

Scenario	Weight
IPO within 180 days	40%
Sale of the Company within 1 year	30%
Private Company	0%
Liquidation	30%

Based on these considerations, the independent third-party valuation suggested that the fair market value of our common stock was $6.24 per share as of July 31, 2013.

The September 2013 valuation used a risk-adjusted discount of 30%, a non-marketability discount of 12-16%, and an estimated time to liquidity event of 0.5 years to 3.0 years, with a weighted average time to exit estimated at 0.63 years. The risk-adjusted discount was estimated to be 30% due to the assumption is that we were in the Bridge / IPO stage of development per AICPA valuation methodologies since we have product revenue and achieved positive EBITDA in 2012. The independent third-party valuation analysis used the following probability weighted scenarios:

Scenario	Weight
IPO within 180 days	60%
Sale of the Company within 1 year	20%
Private Company	0%
Liquidation	20%

Based on these considerations, the independent third-party valuation suggested that the fair market value of our common stock was $8.37 per share as of September 30, 2013.

We believe that it is reasonable to expect that the completion of an initial public offering will add value to the shares of our common stock because they will have increased liquidity and marketability. We believe that the estimates above are a reasonable description of the value that market participants would place on the common stock as of each valuation date. There is inherent uncertainty in these estimates and if we or the valuation firm had made different assumptions than those described above, the amount of our stock-based compensation expense, net loss and net loss per share amounts could have been significantly different.

We note that, as is typical in initial public offerings, the estimated price range for this offering was not derived using a formal determination of fair value, but was determined by negotiation between us and the underwriters. Among the factors that were considered in setting this range were the following:

- an analysis of the typical valuation ranges seen in recent initial public offerings for companies in our industry;
- the general condition of the securities markets and the recent market prices of, and the demand for, publicly traded common stock of generally comparable companies;

Table of Contents

an assumption that there would be a receptive public trading market for a medical technology company such as ours; and

an assumption that there would be sufficient demand for our common stock to support an offering of the size contemplated by this prospectus.

We believe that the difference between the fair value of our common stock as of October 11, 2013 and the assumed initial public offering price in this offering is the result of these factors and the following:

The assumed initial public offering price assumes the completion of a successful initial public offering with no weighting placed on any other outcome for us such as an acquisition. As a result, the assumed initial public offering price effectively weights an initial public offering outcome at 100%. An initial public offering outcome can provide a potentially greater return for the holders of our common stock than a sale or a liquidation due to the elimination of the liquidation preferences of the preferred stock as a result of the conversion of preferred stock to common stock in connection with an initial public offering.

In contrast, at the time of the fair value determination in October 2013, we weighted the potential of an IPO outcome at 60%. Based on market conditions, market uncertainties, developments involving its competitors and other developments, we believed that a liquidation and a sale of us were equally likely outcomes at the time at 20%.

Similarly, because the assumed initial public offering price assumes that the IPO is completed and a public market for our common stock has developed, it excludes any marketability or minority discount for our common stock. The determination of fair value in October 2013 reflected the value of our common stock on a non-marketable, minority basis given the uncertainty of how the market would develop for an initial public offering in the subsequent months.

The assumed initial public offering price also assumes our receipt of the net proceeds from this offering, which proceeds would substantially strengthen our balance sheet and mitigate some of the financial risks associated with remaining a private company.

The NASDAQ Biotechnology Index (^NBI) and the Dow Jones U.S. Select Medical Equipment Total Return Index (^DJSMDQT) increased 18.68% and 11.08%, respectively, from October 11, 2013 to January 10, 2014 and the market for initial public offerings of common stock of similarly situated medical device companies has been favorable.

Our consideration of various objective and subjective factors in the previous fair value determination that are applicable to valuations based on private company valuation methodologies, and which were not taken into account in the analysis performed by the underwriters in considering the estimated preliminary price range for our initial public offering.

Inventory and rental asset valuation

Inventory consists of raw materials, certain component parts to be used in manufacturing our products and finished goods. Inventory is stated at the lower of cost or market. Cost is determined using a standard cost method, including material, labor, and manufacturing overhead, whereby the standard costs are updated at least quarterly to approximate actual costs using the first-in, first-out (FIFO) method and market represents the lower of replacement cost or estimated net realizable value. We record adjustments to inventory for potentially excess,

Table of Contents

obsolete, slow-moving or impaired items. The business environment in which we operate is subject to changes in technology and customer demand. We review inventory for excess and obsolete products and components at least quarterly, taking into account product life cycle and development plans, product expiration and quality issues, historical experience and our current inventory levels. If actual market conditions are less favorable than anticipated, additional inventory adjustments could be required.

Rental assets are valued at standard cost to manufacture or purchase the product, including appropriate labor and overhead. Costs are reviewed at least quarterly to confirm standard costs approximate actual costs using the first-in, first-out (FIFO) method. Rental assets are depreciated over the life of the asset, typically 18 months to 60 months. Rental asset disposals or losses are recorded at net book value in cost of revenue.

Accounts receivable and allowance for bad debts, returns, and adjustments

Accounts receivable are customer obligations due under normal sales and rental terms. We perform continuing credit evaluations of the customers financial condition and generally do not require collateral. The allowance for doubtful accounts is maintained at a level that, in our opinion, is adequate to absorb potential losses related to account receivables and is based upon our continuous evaluation of the collectability of outstanding balances. Our evaluation takes into consideration such factors as past bad debt experience, economic conditions, and information about specific receivables. Our evaluation also considers the age and composition of the outstanding amount in determining their net realizable values. The allowance is based on estimates and ultimate losses may vary from current estimates. As adjustments to these estimates become necessary, they are reported in earnings in the periods that they become known. The allowance is increased by bad debt provisions charged to operating expense and reduced by direct write-offs, net of recoveries. In the event that a third-party payor does not accept the claim for payment, the consumer is ultimately responsible for payment for the products and services.

In general, our allowance for doubtful accounts is higher for our rental revenue compared to our sales revenue. The nature of our rental business necessitates a larger bad debt reserve against billings, as a higher percentage of our billed revenue may never be collected as a result of the failure of some patients to pay their co-insurance and deductible obligations and some billing disputes with payors.

Provision for sales returns applies to direct-to-consumer sales only. We do not allow returns from providers. This reserve is calculated based on actual historical return rates under our 30-day return program and is applied to the current period s sales revenue for direct to consumer sales. We have experienced a small increase in the historical returns rate during the period, primarily due to increased competition among other providers and resellers and a slight increase in product failures in the relevant periods.

We also record an allowance for rental revenue adjustments and write-offs, which is recorded as a reduction of rental revenue and rental accounts receivable balances. These adjustments and write offs result from contractual adjustments, audit adjustments, untimely claims filings or billing not paid due to another provider performing same or similar functions for the patient in the same period, all of which prevent billed revenue to become realizable. The reserve is based on historical revenue adjustments as a percentage of rental revenue billed during the related period.

Included in accounts receivable are earned but unbillemes, serif; VERTICAL-ALIGN: bottom; BORDER-BOTTOM: #000000 1px solid; TEXT-ALIGN: center; MARGIN-LEFT: 0pt" colSpan=2>

Recorded Investment[(1)] in (A) for Which There is a Related Allowance

Related Allowance

Consumer Real Estate[(2)]

Residential closed-end first liens

$718	**$675**	**$306**	**$369**	**$14**
Residential closed-end junior liens				
223	**223**	---	**223**	**7**
Investor-owned residential real estate				
75	**75**	---	**75**	**4**
Commercial Real Estate[2]				
Multifamily real estate				
2,900	**2,665**	**868**	**1,797**	**119**
Commercial real estate, owner-occupied				
4,555	**4,489**	**4,489**	---	---
Commercial real estate, other				
6,013	**5,888**	**5,888**	---	---
Commercial Non Real Estate[2]				
Commercial and Industrial				
1,005	**997**	**997**	**---**	---
Total				
$15,489	**$15,012**	**$12,548**	**$2,464**	**$144**

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(2) Only classes with impaired loans are shown.

	Impaired Loans as of December 31, 2014		
Principal (A) Balance	**Recorded Investment[1]**	**Recorded Investment[1]**	**Related Allowance**

		Total Recorded Investment[1]	in (A) for Which There is No Related Allowance	in (A) for Which There is a Related Allowance	
Consumer Real Estate[2]					
Residential closed-end first liens	$530	$ 503	$ 311	$ 192	$ 2
Residential closed-end junior liens	239	239	---	239	8
Investor-owned residential real estate	77	77	---	77	4
Commercial Real Estate[2]					
Multifamily real estate	2,911	2,735	868	1,866	170
Commercial real estate, owner occupied	4,919	4,821	3,314	1,508	74
Commercial real estate, other	6,080	6,068	3,072	2,996	14
Commercial Non Real Estate[2]					
Commercial and Industrial	678	678	50	628	10
Total	$15,434	$ 15,121	$ 7,615	$ 7,506	$ 282

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(2) Only classes with impaired loans are shown.

The following tables show the average recorded investment and interest income recognized for impaired loans.

	For the Nine Months Ended September 30, 2015	
	Average Recorded Investment	Interest Income Recognized[1]
Consumer Real Estate[2]		
Residential closed-end first liens	**$685**	**$ 33**
Residential closed-end junior liens	**231**	**11**
Investor-owned residential real estate	**76**	**4**
Commercial Real Estate[2]		
Multifamily real estate	**2,670**	---
Commercial real estate, owner occupied	**5,302**	**86**
Commercial real estate, other	**5,924**	**128**
Commercial Non Real Estate[2]		
Commercial and Industrial	**1,014**	**5**
Total	**$15,902**	**$ 267**

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(2) Only classes with impaired loans are shown.

	For the Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized[1]
Consumer Real Estate[2]		
Residential closed-end first liens	$385	$ 19
Residential closed-end junior liens	251	12
Investor-owned residential real estate	78	4
Commercial Real Estate[2]		
Multifamily real estate	2,807	---
Commercial real estate, owner occupied	5,606	153
Commercial real estate, other	6,134	164
Commercial Non Real Estate[2]		

Commercial and Industrial	713	32
Consumer Non Real Estate[2]		
Automobile	---	---
Total	$15,974	$ 384

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(2) Only classes with impaired loans are shown.

	For the Year Ended December 31, 2014	
	Average Recorded Investment[1]	Interest Income Recognized
Consumer Real Estate[2]		
Residential closed-end first liens	555	31
Residential closed-end junior liens	249	16
Investor-owned residential real estate	77	5
Commercial Real Estate[2]		
Multifamily real estate	2,773	---
Commercial real estate, owner occupied	5,836	203
Commercial real estate, other	6,114	175
Commercial Non Real Estate[2]		
Commercial and Industrial	707	43
Total	$16,311	$ 473

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(2) Only classes with impaired loans are shown.

The Company reviews nonaccrual loans on an individual loan basis to determine whether future payments are reasonably assured. To satisfy this criteria, the Company's evaluation must determine that the underlying cause of the original delinquency or weakness that indicated nonaccrual status has been resolved, such as receipt of new guarantees, increased cash flows that cover the debt service or other resolution. Nonaccrual loans that demonstrate reasonable assurance of future payments and that have made at least six consecutive payments in accordance with repayment terms and timeframes may be returned to accrual status.

A restructured loan for which impairment measurement does not indicate a loss and that maintains current status for at least six months may be returned to accrual status.

An analysis of past due and nonaccrual loans follows.

September 30, 2015

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction[1]				
Construction, other	**$27**	**$---**	**$ ---**	**$ ---**
Consumer Real Estate[1]				
Equity lines	**63**	**---**	**---**	**---**
Residential closed-end first liens	**1,305**	**46**	**46**	**3**
Residential closed-end junior liens	**64**	**---**	**---**	
Investor-owned residential real estate	**---**	**---**	**---**	**12**
Commercial Real Estate[1]				
Multifamily real estate	**547**	**2,665**	**---**	**2,665**
Commercial real estate, owner-occupied	**269**	**1,519**	**---**	**2,542**
Commercial real estate, other	**59**	**---**	**---**	**2,883**
Commercial Non Real Estate[1]				
Commercial and Industrial	**71**	**883**	**---**	**883**
Consumer Non Real Estate[1]				
Credit cards	**9**	**1**	**1**	**---**
Automobile	**175**	**---**	**---**	**---**
Other consumer loans	**63**	**---**	**---**	**---**
Total	**$2,652**	**$5,114**	**$ 47**	**$ 8,988**

December 31, 2014

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction[1]				
Construction, other	28	---	---	---
Consumer Real Estate[1]				
Equity Lines	25	---	---	---
Residential closed-end first liens	719	185	80	105
Residential closed-end junior liens	74	1	1	---
Investor-owned residential real estate	336	45	---	59
Commercial Real Estate[1]				

Multifamily real estate	850	868	---	2,735
Commercial real estate, owner occupied	---	1,066	102	2,573
Commercial real estate, other	---	70	---	3,066
Commercial Non Real Estate[(1)]				
Commercial and Industrial	153	43	---	749
Consumer Non Real Estate[(1)]				
Credit cards	3	4	4	---
Automobile	205	20	20	---
Other consumer loans	54	---	---	---
Total	$2,447	$2,302	$ 207	$ 9,287

(1) Only classes with past-due or nonaccrual loans are shown.

The estimate of credit risk for non-impaired loans is obtained by applying allocations for internal and external factors. The allocations are increased for loans that exhibit greater credit quality risk.

Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do not indicate heightened risk are graded as "pass." Loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than 75 days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans with frequent or persistent delinquency exceeding 75 days or that have a higher level of weakness in the borrower's financial condition are graded "classified." Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by 50% and by 100% for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of September 30, 2015 and December 31, 2014.

The following displays collectively-evaluated loans by credit quality indicator.

September 30, 2015

	Pass	Special Mention	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 family residential	**$10,532**	**$ 3,768**	**$ ---**
Construction, other	**30,586**	**---**	**---**
Consumer Real Estate			
Equity lines	**15,715**	**17**	**78**
Closed-end first liens	**78,380**	**464**	**830**
Closed-end junior liens	**4,653**	**55**	**63**
Investor-owned residential real estate	**42,283**	**611**	**868**
Commercial Real Estate			
Multifamily residential real estate	**75,085**	**1,345**	**1,815**
Commercial real estate owner-occupied	**124,459**	**1,278**	**1,316**
Commercial real estate, other	**95,149**	**1,519**	**---**
Commercial Non Real Estate			
Commercial and Industrial	**37,217**	**357**	**684**
Public Sector and IDA			
States and political subdivisions	**52,330**	**---**	**---**
Consumer Non Real Estate			
Credit cards	**5,981**	**---**	**---**
Automobile	**12,134**	**123**	**39**
Other consumer	**11,819**	**31**	**13**
Total	**$596,323**	**$ 9,568**	**$ 5,706**

20

The following displays collectively-evaluated loans by credit quality indicator.

December 31, 2014

	Pass	Special Mention (Excluding Impaired)	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 family residential	$14,222	$ ---	$ 2,265
Construction, other	29,047	---	28
Consumer Real Estate			
Equity lines	15,861	59	60
Closed-end first liens	78,806	1,566	1,412
Closed-end junior liens	4,258	21	95
Investor-owned residential real estate	42,781	688	614
Commercial Real Estate			
Multifamily residential real estate	73,611	1,397	850
Commercial real estate owner-occupied	125,643	202	2,855
Commercial real estate, other	90,821	1,177	582
Commercial Non Real Estate			
Commercial and Industrial	31,247	97	1,390
Public Sector and IDA			
States and political subdivisions	41,361	---	---
Consumer Non Real Estate			
Credit cards	5,705	---	---
Automobile	11,505	93	128
Other consumer	10,745	---	6
Total	$575,613	$ 5,300	$ 10,285

Sales, Purchases and Reclassification of Loans

The Company finances mortgages under “best efforts” contracts with mortgage purchasers. The mortgages are designated as held for sale upon initiation. There have been no reclassifications from portfolio loans to held for sale. There have been no loans held for sale transferred to portfolio loans. Occasionally, the Company purchases or sells participations in loans. All participation loans purchased met the Company’s normal underwriting standards at the time the participation was entered. Participation loans are included in the appropriate portfolio balances to which the allowance methodology is applied.

Troubled Debt Restructurings

The Company modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to $11,861 at September 30, 2015, $11,328 at December 31, 2014, and $8,307 at September 30, 2014. The following tables present restructurings by class that occurred during the nine month periods ended September 30, 2015 and September 30, 2014. The Company did not modify any loans in troubled debt restructures during the three-month periods ended September 30, 2015 or September 30, 2014.

Note: Only classes with restructured loans are presented.

	Restructurings That Occurred During the Nine Months Ended September 30, 2015		
	Number of Contracts	Pre-Modification Outstanding Principal Balance	Post-Modification Outstanding Principal Balance
Commercial Real Estate			
Commercial real estate, owner occupied	**1**	**$ 994**	**$ 907**
Total	**1**	**$ 994**	**$ 907**

During the nine-month period ended September 30, 2015, the Company restructured 1 loan to provide payment relief. The restructuring provided payment relief by reducing principal, capitalizing interest and re-amortizing payments. The restructured loan is in nonaccrual status. The fair value measurement of the restructured loan as of September 30, 2015 resulted in no specific allocations to the allowance for loan losses.

	Restructurings That Occurred During the Nine Months Ended September 30, 2014		
	Number of Contracts	Pre-Modification Outstanding Principal Balance	Post-Modification Outstanding Principal Balance
Commercial Real Estate			
Multifamily real estate	**1**	**$ 2,484**	**$ 2,484**
Commercial real estate, owner occupied	**1**	**184**	**209**
Total	**2**	**$ 2,668**	**$ 2,693**

During the nine-month period ended September 30, 2014, the Company restructured two loans. One multifamily real estate loan was restructured to provide payment relief. The Company reduced the loan's interest rate and re-amortized payments. One commercial real estate, owner occupied loan was restructured pursuant to bankruptcy court orders. The restructuring provided payment relief by capitalizing interest, reducing the interest rate and re-amortizing payments. The fair value measurements of the restructured loans as of September 30, 2014 resulted in specific allocations to the allowance for loan losses totaling $249.

The Company analyzed its TDR portfolio for loans that defaulted during the three and nine month periods ended September 30, 2015 and September 30, 2014, and that were modified within 12 months prior to default. The Company defines default as one or more payments that occur more than 90 days past the due date, charge-offs, or foreclosure after the date of restructuring. There were no restructured loans that defaulted and were modified within 12 months prior to default for the three or nine month periods ended September 30, 2015 and 2014.

Note 5: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type are as follows.

	September 30, 2015			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Available for Sale:				
U.S. Government agencies and corporations	**$190,723**	**$ 757**	**$ 4,557**	**$186,923**
States and political subdivisions	**16,348**	**601**	**---**	**16,949**
Mortgage-backed securities	**1,355**	**137**	**---**	**1,492**
Corporate debt securities	**6,015**	**17**	**300**	**5,732**
Other securities	**189**	**---**	**53**	**136**
Total securities available for sale	**$214,630**	**$ 1,512**	**$ 4,910**	**$211,232**

	December 31, 2014			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Available for Sale:				
U.S. Government agencies and corporations	$197,740	$ 973	$ 4,494	$194,219
States and political subdivisions	18,529	851	---	19,380
Mortgage-backed securities	1,830	184	---	2,014
Corporate debt securities	6,991	140	27	7,104
Other securities	189	---	62	127
Total securities available for sale	$225,279	$ 2,148	$ 4,583	$222,844

The amortized cost and fair value of single maturity securities available for sale at September 30, 2015, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

September 30, 2015

	Amortized Cost	Fair Value
Available for Sale:		
Due in one year or less	**$338**	**$339**
Due after one year through five years	**37,130**	**37,470**
Due after give years through ten years	**27,571**	**27,537**
Due after ten years	**149,402**	**145,750**
No maturity	**189**	**136**
Total securities available for sale	**$214,630**	**$211,232**

The Company holds restricted stock with the Federal Home Loan Bank and the Federal Reserve. Required ownership amounts are determined by the correspondent banks and the Company purchases stock from or sells stock back to the correspondents based on their calculations. The stock is held by member institutions only and is not actively traded. The Company held restricted stock of $1,129 as of September 30, 2015 and $1,089 as of December 31, 2014.

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type are as follows.

	September 30, 2015			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Held to Maturity:				
U.S. Government agencies and corporations	**$14,912**	**$ 343**	**$ 216**	**$15,039**
States and political subdivisions	**137,969**	**5,635**	**1,020**	**142,584**
Mortgage-backed securities	**346**	**40**	**---**	**386**
Corporate debt securities	**1,417**	**18**	**1**	**1,434**
Total securities held to maturity	**$154,644**	**$ 6,036**	**$ 1,237**	**$159,443**

	December 31, 2014			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Held to Maturity:				
U.S. Government agencies and corporations	$18,922	$ 350	$ 245	$19,027
States and political subdivisions	140,702	6,823	727	146,798
Mortgage-backed securities	415	51	---	466
Corporate debt securities	1,413	1	2	1,412
Total securities held to maturity	$161,452	$ 7,225	$ 974	$167,703

The amortized cost and fair value of single maturity securities held to maturity at September 30, 2015, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

	September 30, 2015	
	Amortized Cost	**Fair Value**
Held to maturity:		
Due in one year or less	**$901**	**$909**
Due after one year through five years	**12,890**	**13,781**
Due after give years through ten years	**20,165**	**21,185**
Due after ten years	**120,688**	**123,568**
Total securities held to maturity	**$154,644**	**$159,443**

Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows.

	September 30, 2015			
	Less Than 12 Months		**12 Months or More**	
	Fair Value	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Temporarily Impaired Securities:				
U.S. Government agencies and corporations	**$62,563**	**$ 1,358**	**$89,871**	**$ 3,415**
States and political subdivisions	**19,803**	**415**	**9,774**	**605**
Corporate debt securities	**4,968**	**300**	**200**	**1**
Other securities	**---**	**---**	**136**	**53**
Total	**$87,334**	**$ 2,073**	**$99,981**	**$ 4,074**

	December 31, 2014			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Temporarily Impaired Securities:				
U.S. Government agencies and corporations	$6,964	$ 30	$156,149	$ 4,709
States and political subdivisions	1,222	35	19,818	692
Corporate debt securities	450	2	1,948	27
Other securities	---	---	127	62
Total	$8,636	$ 67	$178,042	$ 5,490

The Company had 210 securities with a fair value of $187,315 that were temporarily impaired at September 30, 2015. The total unrealized loss on these securities was $6,147. Of the temporarily impaired total, 110 securities with a fair value of $99,981 and an unrealized loss of $4,074 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at September 30, 2015 for the reasons set out below.

U.S. Government agencies. The unrealized losses of $4,773 on US Government agency securities stemmed from 157 securities with a fair value of $152,434. The unrealized losses were caused by interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. The Company is monitoring bond market trends and developing strategies to address unrealized losses. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

States and political subdivisions. This category's unrealized losses of $1,020 on 45 securities with a fair value of $29,577 are primarily the result of interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

Corporate. The Company's unrealized losses of $301 on 7 corporate debt securities with a fair value of $5,168 are related to interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

Other securities. The Company holds a small investment in community bank stock. One security with a fair value of $136 has an unrealized loss of $53. The value of this investment has been negatively affected by market conditions. Because the Company does not intend to sell this investment before recovery of its amortized cost basis, the Company does not consider this investment to be other-than-temporarily impaired.

Restricted stock. Restricted stock is reported separately from available-for-sale securities and held-to-maturity securities. As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are

based upon NBB's capital and a percentage of qualifying assets. In addition, NBB is eligible to borrow from the FHLB with borrowings collateralized by qualifying assets, primarily residential mortgage loans and NBB's capital stock investment in the FHLB. Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at September 30, 2015, management did not determine any impairment.

Management regularly monitors the credit quality of the investment portfolio. Changes in ratings are noted and follow-up research on the issuer is undertaken when warranted. Management intends to carefully monitor any changes in bond quality.

Note 6: Recent Accounting Pronouncements

In June 2014, the FASB issued ASU No. 2014-11, “Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures.” This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on our consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, “Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period.” The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in “Compensation – Stock Compensation (Topic 718),” should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The adoption of the new guidance did not have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, “Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern.” This update is intended to provide guidance about management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.

In November 2014, the FASB issued ASU No. 2014-16, “Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity.” The amendments in ASU do not change the current criteria in U.S. GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current U.S.

GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-01, “Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.” The amendments in this ASU eliminate from U.S. GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect the adoption of ASU 2015-01 to have a material impact on its consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." The amendments in this ASU are intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification™ and improves current GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity (VIE), and changing consolidation conclusions for public and private companies in several industries that typically make use of limited partnerships or VIEs. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. ASU 2015-02 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. The Company does not expect the adoption of ASU 2015-02 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The amendments in this ASU are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments in this ASU are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The Company does not expect the adoption of ASU 2015-03 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." The amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer's accounting for service contracts. As a result of the amendments, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets. The amendments in this ASU are effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. An entity can elect to adopt the amendments either: (1) prospectively to all arrangements entered into or materially modified after the effective date; or (2) retrospectively. The Company is currently assessing the impact that ASU 2015-05 will have on its consolidated financial statements.

In May 2015, the FASB issued ASU No. 2015-08, "Business Combinations (Topic 805): Pushdown Accounting – Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115." The amendments in ASU 2015-08 amend various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115, Topic 5: Miscellaneous Accounting, regarding various pushdown accounting issues, and did not have a material impact on our consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-12, "Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965) – 1. Fully Benefit-Responsive Investment Contracts, 2. Plan Investment Disclosures, and 3. Measurement Date Practical

Expedient." The amendments within this ASU are in 3 parts. Among other things, Part 1 amendments designate contract value as the only required measure for fully benefit-responsive investment contracts; Part II amendments eliminate the requirement that plans disclose: (a) individual investments that represent 5 percent or more of net assets available for benefits; and (b) the net appreciation or depreciation for investments by general type requirements for both participant-directed investments and nonparticipant-directed investments. Part III amendments provide a practical expedient to permit plans to measure investments and investment-related accounts (e.g., a liability for a pending trade with a broker) as of a month-end date that is closest to the plan's fiscal year-end, when the fiscal period does not coincide with month-end. The amendments in Parts 1 and 2 of this ASU are effective on a retrospective basis and Part 3 is effective on a prospective basis, for fiscal years beginning after December 15, 2015. Early adoption is permitted. The Company is currently assessing the impact that ASU 2015-12 will have on its consolidated financial statements.

In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date." The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance in ASU 2014-09. The Company does not expect the adoption of ASU 2015-14 (or ASU 2014-09) to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, “Interest – Imputation of Interest (Subtopic 835-30) – Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting).” On April 7, 2015, the FASB issued ASU 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in ASU 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff stated that they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-15 adds these SEC comments to the "S" section of the Codification. The Company does not expect the adoption of ASU 2015-15 to have a material impact on its consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, “Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments.” The amendments in ASU 2015-16 require that an acquirer recognize adjustments to estimated amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record, in the same period’s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the estimated amounts, calculated as if the accounting had been completed at the acquisition date. The amendments also require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not expect the adoption of ASU 2015-16 to have a material impact on its consolidated financial statements.

Note 7: Defined Benefit Plan

Components of Net Periodic Benefit Cost

	Pension Benefits Nine Months Ended September 30,	
	2015	**2014**
Service cost	**$465**	$393

Interest cost	**501**	498
Expected return on plan assets	**(876)**	(834)
Amortization of prior service cost	**(81)**	(81)
Recognized net actuarial loss	**312**	195
Net periodic benefit cost	**$321**	$171

2015 Plan Year Employer Contribution

For the nine months ended September 30, 2015, the Company is not required to make a minimum contribution and has elected not to make a contribution to the Plan.

Note 8: Fair Value Measurements

The Company records fair value adjustments to certain assets and liabilities and determines fair value disclosures utilizing a definition of fair value of assets and liabilities that states that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Additional considerations come into play in determining the fair value of assets in markets that are not active.

The Company uses a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

Level 1 –	Valuation is based on quoted prices in active markets for identical assets and liabilities.
Level 2 –	Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
Level 3 –	Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain assets and liabilities recorded at fair value on a recurring basis in the financial statements.

Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

Description	**Balance as of September 30, 2015**	**Fair Value Measurements at September 30, 2015 Using Quoted Prices in Active Markets for Identical Assets (Level**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**

		1)			
U.S. Government agencies and corporations	**$ 186,923**	**$---**	**$ 186,923**	**$**	**---**
States and political subdivisions	**16,949**	**---**	**16,949**		**---**
Mortgage-backed securities	**1,492**	**---**	**1,492**		**---**
Corporate debt securities	**5,732**	**---**	**5,732**		**---**
Other securities	**136**	**---**	**136**		**---**
Total securities available for sale	**$ 211,232**	**$---**	**$ 211,232**	**$**	**---**

Description	**Balance as of December 31, 2014**	**Fair Value Measurements at December 31, 2014 Using Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	
U.S. Government agencies and corporations	$ 194,219	$---	$ 194,219	$	---
States and political subdivisions	19,380	---	19,380		---
Mortgage-backed securities	2,014	---	2,014		---
Corporate debt securities	7,104	---	7,104		---
Other securities	127	---	127		---
Total securities available for sale	$ 222,844	$---	$ 222,844	$	---

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements.

Loans Held for Sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets offer at the report date for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at September 30, 2015 or December 31, 2014.

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due will not be collected when due according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan's balance exceeds fair value, the amount is allocated to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The fair value of an impaired loan and measurement of associated loss is based on one of three methods: the observable market price of the loan, the present value of projected cash flows, or the fair value of the collateral. The observable market price of a loan is categorized as a Level 1 input. The present value of projected cash flows method results in a Level 3 categorization because the calculation relies on the Company's judgment to determine projected cash flows, which are then discounted at the current rate of the loan, or the rate prior to modification if the loan is a troubled debt restructure.

Loans measured using the fair value of collateral method may be categorized in Level 2 or Level 3. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of $250 or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of $100 or greater and secured by one piece of collateral. Collateral-method impaired loans with principal balances below $100, or if secured by multiple pieces of collateral, below $250, are valued using an internal evaluation.

The value of real estate collateral is determined by a current (less than 12 months of age) appraisal or internal evaluation utilizing an income or market valuation approach. Appraisals conducted by an independent, licensed appraiser outside of the Company using observable market data are categorized as Level 2. If a current appraisal cannot be obtained prior to a reporting date and an existing appraisal is discounted to obtain an estimated value, or if declines in value are identified after the date of the appraisal, or if an appraisal is discounted for estimated selling costs, the valuation of real estate collateral is categorized as Level 3. Valuations derived from internal evaluations are categorized as Level 3. The value of business equipment is based upon an outside appraisal (Level 2) if deemed significant, or the net book value on the applicable business' financial statements (Level 3) if not considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement

balances or aging reports (Level 3).

Impaired loans are measured quarterly for impairment. The Company employs the most applicable valuation method for each loan based on current information at the time of valuation. Valuations of loans using the collateral method may include a discount for selling costs if collection of the loan is expected to come from sale of the collateral. Fair value measurement using the collateral method for a loan that is dependent on the operation, but not the sale, of collateral for collection is not discounted for selling costs.

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at September 30, 2015 and at December 31, 2014.

Date	Description	Balance	Carrying Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
September 30, 2015	Impaired loans net of valuation allowance	**$ 2,320**			**$ 2,320**
December 31, 2014	Impaired loans net of valuation allowance	7,224	---	---	7,224

The following tables present information about Level 3 Fair Value Measurements for September 30, 2015 and December 31, 2014.

September 30, 2015	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	Present value of cash flows	Market rate for borrower (discount rate)	5.88% - 7.25% (6.19%)

December 31, 2014	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	Present value of cash flows	Discount rate	5.88% - 9.50% (6.15%)
Impaired loans	Discounted appraised value	Selling cost[1]	10% [2]

(1) Impaired loans that are collateral-dependent are valued using the fair value of collateral. The valuation is discounted for selling costs if repayment of the loan is dependent on the sale of the collateral. If repayment will come from rental income of the property, the valuation is not discounted for selling costs.

(2) Only one loan was valued using the collateral method as of December 31, 2014.

Other Real Estate Owned

Other real estate owned are real estate assets acquired in full or partial satisfaction of a loan. At acquisition, other real estate owned assets are measured at fair value. If the assets are marketed for sale by an outside party, the acquisition-date fair value is discounted by selling costs; if the assets are marketed for sale by the Company, no reduction to fair value for selling costs is made. Subsequent to acquisition, the assets are measured at the lower of initial measurement or current fair value, discounted for selling costs as appropriate.

The fair value of an other real estate owned asset is determined by an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). If the appraisal is discounted either for age or because management considers the real estate market to be experiencing volatility, then the fair value is considered Level 3. Discounts for selling costs also result in measurement based on Level 3 inputs. Fair value adjustments are measured on a nonrecurring basis and are recorded in the period incurred as valuation allowances to other real estate owned, and expensed through noninterest expense.

The following table summarizes the Company’s other real estate owned that was measured at fair value on a nonrecurring basis.

	Carrying Value

Date	Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
September 30, 2015	Other real estate owned net of valuation allowance	**$ 4,194**			**$ 4,194**
December 31, 2014	Other real estate owned net of valuation allowance	4,744	---	---	4,744

The following tables present information about Level 3 Fair Value Measurements for September 30, 2015 and December 31, 2014.

September 30, 2015	Valuation Technique	Unobservable Input	Range (Weighted Average)	
Other real estate owned	Discounted appraised value	Selling cost	0%[(1)] – 11.11%	(6.04%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0% - 49.44%	(9.51%)

December 31, 2014	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value	Selling cost	0%[1] - 11% (8.60%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0% - 48.77% (20.81%)

(1) The Company markets other real estate owned both independently and with local realtors. Properties marketed by realtors are discounted by selling costs. Properties that the Company markets independently are not discounted by selling costs.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments.

Cash and Due from Banks and Interest-Bearing Deposits

The carrying amounts approximate fair value.

Securities

The fair value of securities, excluding restricted stock, is determined by quoted market prices or dealer quotes. The fair value of certain state and municipal securities is not readily available through market sources other than dealer quotations, so fair value estimates are based on quoted market prices of similar instruments adjusted for differences between the quoted instruments and the instruments being valued. The carrying value of restricted securities approximates fair value based upon the redemption provisions of the applicable entities.

Loans Held for Sale

The fair value of loans held for sale is based on commitments on hand from investors or prevailing market prices.

Loans

Fair value for the loan portfolio is estimated on an account-level basis by discounting scheduled cash flows through the projected maturity for each loan. The calculation applies estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified by an estimate of the effect of economic conditions on lending.

Impaired loans are individually evaluated for fair value. Fair value for the Company's impaired loans is estimated by using either discounted cash flows or the appraised value of collateral. Any amount of principal balance that exceeds fair value is accrued in the allowance for loan losses. Assumptions regarding credit risk, cash flows and discount rates are determined within management's judgment, using available market information and specific borrower information. Discount rates for cash flow analysis are based on the loan's interest rate, and cash flows are estimated based upon the loan's historical payment performance and the borrower's current financial condition. Appraisals may be discounted for age, reasonableness, and selling costs.

Deposits

The fair value of demand and savings deposits is the amount payable on demand. The fair value of fixed maturity term deposits and certificates of deposit is estimated using the rates currently offered for deposits with similar remaining maturities.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Bank-Owned Life Insurance

Bank owned life insurance represents insurance policies on officers of the Company and certain officers who are no longer employed by the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are not deemed significant at September 30, 2015 and December 31, 2014, and, as such, the related fair values have not been estimated.

The estimated fair values and related carrying amounts of the Company's financial instruments follow.

	September 30, 2015			
	Carrying Amount	**Quoted Prices in Active Markets for Identical Assets Level 1**	**Significant Other Observable Inputs Level 2**	**Significant Unobservable Inputs Level 3**
Financial Assets:				
Cash and due from banks	**$ 12,446**	**$ 12,446**	**$ ---**	**$ ---**
Interest-bearing deposits	**90,295**	**90,295**	**---**	**---**
Securities	**365,876**	**---**	**370,675**	**---**
Restricted securities	**1,129**	**---**	**1,129**	**---**
Loans held for sale	**1,331**	**---**	**1,331**	**---**
Loans, net	**617,638**	**---**	**---**	**628,160**
Accrued interest receivable	**5,659**	**---**	**5,659**	**---**
Bank-owned life insurance	**22,248**	**---**	**22,248**	**---**
Financial Liabilities:				
Deposits	**$ 962,530**	**$ ---**	**$ 765,359**	**$ 196,097**
Accrued interest payable	**61**	**---**	**61**	**---**

	December 31, 2014			
	Carrying Amount	**Quoted Prices in Active Markets for Identical**	**Significant Other Observable Inputs**	**Significant Unobservable Inputs**
			Level 2	**Level 3**

	Assets			
		Level 1		
Financial Assets:				
Cash and due from banks	$12,894	$12,894	$ ---	$ ---
Interest-bearing deposits	102,548	102,548	---	---
Securities	384,296	---	390,547	---
Restricted securities	1,089	---	1,089	---
Loans held for sale	291	---	291	---
Loans, net	597,203	---	---	633,063
Accrued interest receivable	5,748	---	5,748	---
Bank-owned life insurance	21,797	---	21,797	---
Financial Liabilities:				
Deposits	$982,428	$---	$ 765,682	$ 216,469
Accrued interest payable	68	---	68	---

Note 9: Components of Accumulated Other Comprehensive Loss

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive (Loss)
Balance at December 31, 2013	$ (14,011)	$ (2,953)	$ (16,964)
Unrealized holding gains on available for sale securities net of tax of $4,264	7,920	---	7,920
Reclassification adjustment for gains included in net income, net of tax of ($1)	(3)	---	(3)
Balance at September 30, 2014	$ (6,094)	$ (2,953)	$ (9,047)
Balance at December 31, 2014	$ (1,582)	$ (4,090)	$ (5,672)
Unrealized holding losses on available for sale securities net of tax of ($334)	(624)	---	(624)
Reclassification adjustment for gains included in net income, net of tax of ($2)	(3)	---	(3)
Balance at September 30, 2015	**$ (2,209)**	**$ (4,090)**	**$ (6,299)**

The following provides information regarding reclassifications out of accumulated comprehensive income (loss) for the three month and nine month periods ended September 30, 2015 and September 30, 2014.

	3 Months Ended September 30, 2015	3 Months Ended September 30, 2014	9 Months Ended September 30, 2015	9 Months Ended September 30, 2014
Reclassifications out of unrealized gains and losses on available-for-sale securities:				
Realized securities gains, net	**$ 2**	$ 4	**$ 5**	$ 4
Income taxes	**1**	1	**2**	1
Realized gains on available-for-sale securities, net of tax, reclassified out of accumulated other comprehensive income	**$ 1**	$ 3	**$ 3**	$ 3

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

$ in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the “Company”), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Please refer to the financial statements and other information included in this report as well as the 2014 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

Cautionary Statement Regarding Forward-Looking Statements

We make forward-looking statements in this Form 10-K that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management’s views and assumptions as of the date of this report. The words “believes,” “expects,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “forecasts,” “intends,” or other similar words or terms are intended to identify forward-looking statements.

These forward-looking statements are based upon or are affected by factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. These factors include, but are not limited to, changes in:

- interest rates,
- general economic conditions,
- the legislative/regulatory climate,
- monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 (“EESA”) the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) and other financial reform legislation,
- unanticipated increases in the level of unemployment in the Company’s trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company’s trade area,
- the real estate market in the Company’s trade area,
- the Company’s technology initiatives, and
- applicable accounting principles, policies and guidelines.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained in this report. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report. This discussion and analysis should be read in conjunction with the description of our “Risk Factors” in Item 1A. of this Form 10-K.

The national economy and the Company’s market area have experienced a slow recovery since the economic recession of 2008 and 2009. Unemployment rates have slowly improved since the peak of the recession, but are still higher than pre-recession levels. If the economic recovery wavers or reverses, it is likely that unemployment will continue at higher-than-normal levels or rise and that other economic indicators will negatively impact the Company’s trade area. Because of the importance to the Company’s markets of state-funded universities, cutbacks in the funding provided by the State as a result of the recession could also negatively impact employment. This could lead to a higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company’s business and professional customers. A slow economic recovery could have an adverse effect on all financial institutions, including the Company.

Critical Accounting Policies

General

The Company’s financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. The Company uses historical loss rates as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from one previously acceptable method to another method. Although the economics of the Company’s transactions would be the same, the timing of events that would impact the transactions could change.

Allowance for Loan Losses

The allowance for loan losses is an accrual of estimated losses that have been sustained in our loan portfolio. The allowance is funded by the provision for loan losses, reduced by charge-offs of loans and increased by recoveries of previously charged-off loans. The determination of the allowance is based on two accounting principles, Accounting Standards Codification ("ASC") Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss is reasonably estimable, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

Probable losses are accrued through two calculations, individual evaluation of impaired loans and collective evaluation of the remainder of the portfolio. Impaired loans are larger non-homogeneous loans for which there is a probability that collection will not occur according to the loan terms, as well as loans whose terms have been modified in a troubled debt restructuring. Impaired loans that are not TDR's with an estimated impairment loss are placed on nonaccrual status. TDR's with an impairment loss may accrue interest if they have demonstrated six months of timely payment performance.

Impaired loans

Impaired loans are identified through the Company's credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan's fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral ("collateral method"), the present value of future cash flows ("cash flow method"), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is eminent and to loans for which the fair value of collateral is a more reliable estimate of fair value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of $250 or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of $100 or greater and secured by one piece of collateral. Collateral-method impaired loans with principal balances below $100, or if secured by multiple pieces of collateral, below $250, are valued using an internal evaluation.

Appraisals and internal valuations provide an estimate of market value. Appraisals must conform to the Uniform Standards of Professional Appraisal Practice ("USPAP") and are prepared by an independent third-party appraiser who is certified and licensed and who is approved by the Company. Appraisals incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value. Internal evaluations are prepared and reviewed by employees of the Company who are independent of the loan origination, operation, management and collection functions. Evaluations provide a property's market value based on the property's current physical condition and characteristics and the economic market conditions that affect the collateral's market value. Evaluations incorporate multiple sources of data to arrive at a property's market value, including physical inspection, tax values, independent third-party automated tools, comparable sales analysis and local market information.

Updated appraisals or evaluations are ordered when the loan becomes impaired if the appraisal or evaluation on file is more than twelve months old. Appraisals and evaluations are reviewed for propriety and reasonableness and may be discounted if the Company determines that the value exceeds reasonable levels. If an updated appraisal or evaluation has been ordered but has not been received by a reporting date, the fair value may be based on the most recent available appraisal or evaluation, discounted for age.

The appraisal or evaluation value for a collateral-dependent loan for which recovery is expected solely from the sale of collateral is reduced by estimated selling costs. Estimated losses on collateral-dependent loans, as well as any other impairment loss considered uncollectible, are charged against the allowance for loan losses. For loans that are not collateral dependent, the impairment loss is accrued in the allowance. Impaired loans with partial charge-offs are maintained as impaired until the remaining balance is satisfied. Smaller homogeneous impaired loans that are not troubled debt restructurings or part of a larger impaired relationship are collectively evaluated.

Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment with at least six months of consecutive timely payment performance, unless the impairment measurement indicates a loss.

Collectively-evaluated loans

Non-impaired loans and smaller homogeneous impaired loans that are not troubled debt restructurings and not part of a larger impaired relationship are grouped by portfolio segments that are made up of smaller loan classes. Loans within a segment or class have similar risk characteristics.

Probable loss is determined by applying historical net charge-off rates as well as additional percentages for trends and current levels of quantitative and qualitative factors. Loss rates are calculated for and applied to individual classes. Beginning with the first quarter of 2014, the Company began calculating the applicable loss rates by averaging loss rates over the most recent 8 quarters. Prior to 2014, the Company annualized the current year-to-date loss rate and averaged it with the loss rate of the previous year. The two methods yield similar results, and at the end of the year will yield the same average loss rate. The Company transitioned to using 8 quarters in order to provide ease of calculation on an ongoing basis. The look-back periods of 8 quarters beginning in 2014 and two years for periods ended December 31, 2013 and prior are applied consistently among all classes.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance (“class loss rate”), and total net charge-offs for the class as a percentage of average classified loans in the class (“classified loss rate”). Classified loans are those with risk ratings of “substandard” or higher. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

Trends and current levels of qualitative factors are evaluated and allocations are applied to each class. Qualitative factors include delinquency rates, loan quality and concentrations, loan officers’ experience, changes in lending policies and changes in the loan review process. Economic factors such as unemployment rates, bankruptcy rates and others are also evaluated, with standard allocations applied consistently to relevant classes.

The Company accrues additional estimated loss for criticized loans within each class and for loans designated high risk. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with terms that require only interest payments. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

Estimation of the allowance for loan losses

The estimation of the allowance involves analysis of internal and external variables, methodologies, assumptions and our judgment and experience. Key judgments used in determining the allowance for loan losses include internal risk rating determinations, market and collateral values, discount rates, loss rates, and our view of current economic conditions. These judgments are inherently subjective and our actual losses could be greater or less than the estimate. Future estimates of the allowance could increase or decrease based on changes in the financial condition of individual borrowers, concentrations of various types of loans, economic conditions or the markets in which collateral may be sold. The estimate of the allowance accrual determines the amount of provision expense and directly affects our financial results.

The estimate of the allowance for September 30, 2015 considered market and portfolio conditions during the first nine months of 2015 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended September 30, 2015. Given the continued economic difficulties, the ultimate amount of loss could vary from

that estimate. For additional discussion of the allowance, see Note 4 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

Goodwill and Core Deposit Intangibles

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company’s most recent impairment test was performed in the fourth quarter of 2014. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. The Company opted not to perform the preliminary assessment. The Company’s goodwill impairment analysis considered three valuation techniques appropriate to the measurement. The first technique uses the Company’s market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to the Company; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to the Company. Each measure indicated that the Company’s fair value exceeded its book value, validating that goodwill is not impaired.

Certain key judgments were used in the valuation measurement. Goodwill is held by the Company’s bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company’s assets are comprised of the subsidiary bank’s equity, the Company’s market capitalization was used to estimate the Bank’s market capitalization. Other judgments include the assumption that the companies and transactions used as comparables for the second and third technique were appropriate to the estimate of the Company’s fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.

Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company amortizes intangible assets arising from branch transactions over their useful life. Core deposit intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

Overview

National Bankshares, Inc. (“NBI”) is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg (“NBB” or “the Bank”) and National Bankshares Financial Services, Inc. (“NBFS”). NBB, which does business as National Bank from twenty-six office locations, is a community bank. NBB is the source of nearly all of the Company’s revenue. NBFS does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

NBI common stock is listed on the NASDAQ Capital Market and is traded under the symbol “NKSH.” National Bankshares, Inc. has been included in the Russell Investments Russell 3000 and Russell 2000 Indexes since September 29, 2009.

Lending

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, small and mid-sized businesses, non-profits and local governments. Loan types include commercial and agricultural, commercial real estate, construction for commercial and residential properties, residential real estate, home equity and various consumer loan products. Of primary consideration in the Bank’s decision to extend credit is the repayment ability of the borrowers and (if secured) the collateral value in relation to the principal balance. Collateral value lowers risk and may be used as a secondary source of repayment. The credit decision is supported by documentation appropriate to the type of loan, including current financial information, income verification or cash flow analysis, tax returns, credit reports, collateral information, guarantor verification, title reports, appraisals (where appropriate), and other documents. A discussion of underwriting policies and procedures specific to the major loan products follows.

Commercial and agricultural loans primarily finance equipment acquisition, expansion, working capital, and other general business purposes. Because these loans have a higher degree of risk, the Bank generally obtains collateral such as inventories, accounts receivable or equipment, and personal guarantees from the borrowing entity’s principal owners. The Bank’s policy limits lending to 60% of the appraised value for inventory and equipment and up to 70% for accounts receivables less than 90 days old. Credit decisions are based upon an assessment of the financial capacity of the applicant, including the primary borrower’s ability to repay within proposed terms, a risk assessment, financial strength of guarantors and adequacy of collateral. Credit agency reports of individual owners’ credit history supplement the analysis.

Commercial mortgages and construction loans are offered to investors, developers and builders, primarily within the Bank's market area in southwest Virginia. These loans are secured by first mortgages on real estate. The loan amount is generally limited to 80% of the collateral value, and is individually determined based on the property type, quality, location and sponsorship. Commercial properties include retail centers, apartments, and industrial properties.

Underwriting decisions are based upon an analysis of the economic viability of the collateral and creditworthiness of the borrower. The Bank obtains appraisals from qualified certified independent appraisers to establish the value of collateral properties. The property's projected net cash flows compared to the debt service requirement (the "debt service coverage ratio" or "DSC" ratio) is required to be 110% or greater, and is computed after deduction for a vacancy factor and property expenses, as appropriate. Borrower cash flow may be supplemented by a personal guarantee from the principal(s) of the borrower, and guarantees from other parties. The Bank requires title insurance, fire, and extended coverage casualty insurance, and flood insurance, if appropriate, in order to protect the security interest in the underlying property. In addition, the Bank may employ stress testing techniques to determine repayment ability in a changing rate environment before granting loan approval.

Construction loans are underwritten against projected cash flows from rental income, business and/or personal income from an owner-occupant or the sale of the property to an end-user. Associated risks may be mitigated by requiring fixed-price construction contracts, performance and payment bonding, controlled disbursements, and pre-sale contracts or pre-lease agreements.

The Bank offers a variety of first mortgage and junior lien loans secured by 1-4 family residences to individuals within our markets. Credit decisions are primarily based on loan-to-value ("LTV") ratios, debt-to-income ("DTI") ratios, liquidity, net worth, and DSC ratios. Income and financial information is obtained from personal tax returns, personal financial statements, credit reports and employment documentation. A maximum LTV ratio of 80% is generally required, although higher levels are permitted. The debt-to-income ratio is limited to 43% of gross income.

Consumer real estate mortgages may have fixed interest rates for the entire term of the loan or variable interest rates subject to change after the first, third, or fifth year. Variable rates are based on the weekly average yield of United States Treasury Securities and are underwritten at fully-indexed rates. We do not offer consumer real estate interest-only loans, sub-prime loans, or any variation on sub-prime lending including hybrid loans and payment option ARMs, or any product with negative amortization. Sub-prime loans involve extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. Payment option ARMs usually have adjustable rates, for which borrowers choose their monthly payment of either a full payment, interest only, or a minimum payment which may be lower than the payment required to reduce the balance of the loan in accordance with the originally underwritten amortization.

Home equity loans are secured primarily by second mortgages on residential property. The underwriting policy for home equity loans generally permits aggregate (the total of all liens secured by the collateral property) borrowing availability up to 80% of the appraised value of the collateral. We offer variable rate home equity loans, with variable rate loans underwritten at fully-indexed rates. Decisions are primarily based on LTV ratios, DTI ratios and liquidity. We do not offer home equity loan products with reduced documentation.

Automobile loans include loans secured by new or used automobiles. Automobile loans are originated either on a direct basis or on an indirect basis through selected dealerships. We require borrowers to maintain collision insurance on automobiles securing consumer loans. Our procedures for underwriting automobile loans include an assessment of an applicant's overall financial capacity, including credit history and the ability to meet existing obligations and payments on the proposed loan. Although an applicant's creditworthiness is the primary consideration, the underwriting process also includes a comparison of the value of the collateral security to the proposed loan amount.

Performance Summary

The following table presents the Company's key performance ratios for the three and nine months ended September 30, 2015 and the year ended December 31, 2014. The measures for September 30, 2015 are annualized, except for basic earnings per share and fully diluted earnings per share.

	Three Months Ended September 30, 2015	**September, 2014**	
Return on average assets	**1.46%**	1.51	%
Return on average equity	**9.70%**	10.55	%
Basic earnings per share	**$0.60**	$ 0.61	
Fully diluted earnings per share	**$0.60**	$ 0.61	
Net interest margin [1]	**3.89%**	3.98	%
Noninterest margin [2]	**1.40%**	1.37	%

[1] Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

[2] Noninterest margin: Noninterest expense (excluding the provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The annualized return on average assets declined 5 basis points for the three months ended September 30, 2015, compared with the three months ended September 30, 2014. The annualized return on average equity decreased 85 basis points for the same period.

The annualized net interest margin was 3.89% for the three months ended September 30, 2015, down 9 basis points from the 3.98% reported for the three months ended September 30, 2014. The primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets.

The annualized noninterest margin increased 3 basis points from the three months ended September 30, 2014. Please refer to the discussion under noninterest expense for further information.

	Nine Months Ended September 30, 2015		Twelve Months Ended December 31, 2014	
Return on average assets	**1.43**	**%**	1.51	%
Return on average equity	**9.60**	**%**	10.72	%
Basic earnings per share	**$ 1.77**		$ 2.43	
Fully diluted earnings per share	**$ 1.76**		$ 2.43	
Net interest margin [1]	**3.90**	**%**	4.01	%
Noninterest margin [2]	**1.44**	**%**	1.38	%

[1] Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

[2] Noninterest margin: Noninterest expense (excluding the provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The annualized return on average assets declined 8 basis points for the nine months ended September 30, 2015, compared with the year ended December 31, 2014. The annualized return on average equity decreased 112 basis points for the same period.

The annualized net interest margin was 3.90% for the nine months ended September 30, 2015, down 11 basis points from the 4.01% reported for the year ended December 31, 2014. As with the three-month periods ended September 30, 2015 and September 30, 2014, the primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets.

The annualized noninterest margin increased 6 basis points from the year ended December 31, 2014. Please refer to the discussion under noninterest expense for further information.

Growth

NBI's key growth indicators are shown in the following table.

	September 30, 2015	December 31, 2014	Percent Change	
Interest-bearing deposits	**$90,295**	$102,548	**(11.95**	)%
Securities, at carrying value	**367,005**	385,385	**(4.77**	)%
Loans, net	**617,638**	597,203	**3.42**	**%**

Deposits	**962,530**	982,428	**(2.03**	)%
Total assets	**1,144,125**	1,154,731	**(0.92**	)%

Asset Quality

Key indicators of the Company's asset quality are presented in the following table.

	September 30, 2015		**September 30, 2014**		**December 31, 2014**	
Nonperforming loans	**$ 8,988**		$ 7,726		$ 9,287	
Loans past due 90 days or more, and still accruing	**47**		485		207	
Other real estate owned	**4,194**		5,145		4,744	
Allowance for loan losses to loans	**1.30**	**%**	1.35	%	1.36	%
Net charge-off ratio	**0.19**	**%**	0.31	%	0.27	%
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	**2.09**	**%**	2.14	%	2.30	%
Ratio of allowance for loan losses to nonperforming loans	**90.31**	**%**	103.95	%	88.97	%

The Company's risk analysis determined an allowance for loan losses of $8,117 at September 30, 2015, a decrease from $8,263 at December 31, 2014 and an increase from $8,031 at September 30, 2014. The provision for the nine months ended September 30, 2015 was $734, a decline from $1,160 for the same period in 2014. The ratio of allowance for loan losses to loans is 1.30% as of September 30, 2015, compared with 1.36% December 31, 2014 and 1.35% at September 30, 2014. The decline in the ratio of the allowance for loan losses to loans was primarily driven by improvements in the net charge-off ratio, loans past due 90 days or more and still accruing, nonaccrual loans and criticized loans, as well as improvements in certain economic factors. The improvements resulted in a positive effect on the ratio of the allowance for loan losses to total loans, partially offset by an increase in loans past due 30-89 days and a decline in certain economic factors.

Asset quality indicators that improved from December 31, 2014 include the net charge-off ratio, the percentage of loans 90 days past due, the percentage of nonaccrual loans and the level of criticized loans. The net charge-off percentage improved from 0.27% for the year ended December 31, 2014 to 0.19% for September 30, 2015. The percentage of loans 90 days past due improved from 0.03% at December 31, 2014 and 0.08% at September 30, 2014 to 0.01% at September 30, 2015. Nonaccrual loans as a percentage of total loans improved from 1.53% at December 31, 2014 to 1.44% at September 30, 2015. Criticized loans as a percentage of total loans decreased to 4.49% at September 30, 2015, compared with 5.01% at December 31, 2014. These improvements were slightly offset by a small increase in the level of loans past due 30-89 days, from 0.40% of loans at December 31, 2014 to 0.42% of loans at September 30, 2015.

Economic factors were analyzed to determine their impact on the credit risk of the loan portfolio. Within the Company's market area, inventory of new and existing homes and the unemployment rate indicated a slight improvement, while personal and business bankruptcy rates worsened. Other factors including competition, legal and regulatory environments, residential vacancy rate and the interest rate environment remained at similar levels to the previous quarter.

Asset quality indicators, loss rates and economic factors impact the estimate of the allowance for collectively evaluated loans. Specific allocations for individually-evaluated impaired loans are determined through detailed analysis of cash flow and collateral valuations estimates. The allowance appears to be at a reasonable level based on the credit quality and economic indicators that impact credit risk. The Company continues to monitor risk within the loan portfolio.

The following table discloses the other real estate owned in physical possession and in process at reporting date:

Other Real Estate Owned[1]	**September 30,**	**September 30,**	**December 31,**
	2015	**2014**	**2014**
Real estate construction	**$ 3,205**	**$ 3,662**	$ 3,599
Consumer real estate	**357**	**---**	67
Commercial real estate	**632**	**1,483**	1,078
Total other real estate owned	**$ 4,194**	**$ 5,145**	$ 4,744
Other real estate owned in process	**$ 151**	**$ 933**	$ 1,260

(1) Net of valuation allowance.

Other real estate owned decreased $550 from December 31, 2014 and $951 from September 30, 2014. As of September 30, 2015, total residential properties approximating $151 are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB's other real estate owned properties are regularly marketed and sold.

The recent economic recession and slow recovery have contributed to levels of asset quality measures that are higher than normal for the Company. The Company continues to monitor risk levels within the loan portfolio. Please refer to Note 4: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for further information on collectively-evaluated loans, individually-evaluated impaired loans and the unallocated portion of the allowance for loan losses.

Modifications and Troubled Debt Restructurings ("TDRs")

In the ordinary course of business, the Company modifies loan terms on a case-by-case basis, including both consumer and commercial loans, for a variety of reasons. Modifications to consumer loans generally involve short-term deferrals to accommodate specific, temporary circumstances. The Company may grant extensions to borrowers who have demonstrated a willingness and ability to repay their loan but who are dealing with the consequences of a specific unforeseen temporary hardship.

An extension defers monthly payments and requires a balloon payment at the original contractual maturity. Where the temporary event is not expected to impact a borrower's ability to repay the debt, and where the Company expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay at contractual maturity, the modification is not designated a TDR.

Modifications to commercial loans may include, but are not limited to, changes in interest rate, maturity, amortization and financial covenants. In the original underwriting, loan terms are established that represent the then-current and projected financial condition of the borrower. If the modified terms are consistent with competitive market conditions and are representative of terms the borrower could otherwise obtain in the open market, the modified loan is not categorized as a TDR.

The Company tracks modifications to assist in identifying troubled debt restructurings. The majority of modifications granted during the first nine months of 2015 and 2014 were granted for competitive reasons and did not constitute troubled debt restructurings. A description of modifications that did not result in troubled debt restructurings for the first nine months of 2015 and 2014 follows:

Nine Months Ended September 30, 2015

Modifications To Borrowers Not Experiencing Financial Difficulty	**Number of Loans Modified**	**Total Amount Modified (in thousands)**
Rate reductions for competitive purposes	**87**	**$ 53,694**
Payment extensions for less than 3 months	**94**	**2,888**
Maturity date extensions of more than 3 months and up to 6 months	**231**	**26,262**
Maturity date extensions of more than 6 months and up to 12 months	**264**	**12,684**
Maturity date extensions of more than 12 months	**3**	**285**
Advances on non-revolving loans or capitalization	**2**	**1,076**
Change in amortization term or method	**11**	**2,290**
Renewal of expired Home Equity Line of Credit loans for additional 10 years	**31**	**745**
Renewal of single-payment notes	**228**	**4,393**
Total modifications that do not constitute TDRs	**951**	**$ 104,317**

Nine Months Ended September 30, 2014

Modifications To Borrowers Not Experiencing Financial Difficulty	**Number of Loans Modified**	**Total Amount Modified (in thousands)**
Rate reductions for competitive purposes	57	$ 22,206
Payment extensions for less than 3 months	166	4,546
Maturity date extensions of more than 3 months and up to 6 months	246	69,849
Maturity date extensions of more than 6 months and up to 12 months	293	12,369
Maturity date extensions of more than 12 months	17	4,716
Change in amortization term or method	39	7,866
Renewal of expired Home Equity Line of Credit loans for additional 10 years	36	495

Renewal of single-payment notes	291	5,923
Total modifications that do not constitute TDRs	1,145	$ 127,970

Modifications in which the borrower is experiencing financial difficulty and in which the Company makes a concession to the original contractual loan terms are designated troubled debt restructurings.

Modifications of loan terms to borrowers experiencing financial difficulty are made in an attempt to protect as much of the Company's investment in the loan as possible. The determination of whether a modification should be accounted for as a TDR requires significant judgment after consideration of all facts and circumstances surrounding the transaction.

The Company recognizes that the current economy, elevated levels of unemployment and depressed real estate values have resulted in financial difficulties for some customers. The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure. All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans that do not demonstrate current payments for at least six months are maintained as nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

The Company's TDRs were $11,861 at September 30, 2015, an increase from $11,328 at December 31, 2014. Accruing TDR loans amounted to $6,080 at September 30, 2015 and $6,040 at December 31, 2014. TDRs with a current payment history with at least six months may accrue interest.

	TDR Status as of September 30, 2015				
		Accruing			
	Total TDR Loans	**Current**	**30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Consumer real estate	**$973**	**$973**	**$ ---**	**$ ---**	**$ ---**
Commercial real estate	**10,874**	**5,093**	**---**	**---**	**5,781**
Commercial non real estate	**14**	**14**	**---**	**---**	**---**
Total TDR Loans	**$11,861**	**$6,080**	**$ ---**	**$ ---**	**$ 5,781**

	TDR Status as of December 31, 2014				
		Accruing			
	Total TDR Loans	**Current**	**30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Consumer real estate	$819	$786	$ ---	$ 33	$ ---
Commercial real estate	10,480	5,192	---	---	5,288
Commercial non real estate	29	29	---	---	---
Total TDR Loans	$11,328	$6,007	$ ---	$ 33	$ 5,288

Restructuring generally results in a loan with either lower payments or a maturity extended beyond that originally required, and is expected to result in a lower risk of loss associated with nonperformance than the pre-modified loan. During the first nine months of 2015, the Company modified in a troubled debt restructure one loan with a post-modification balance of $907. During the first nine months of 2014, the Company modified in troubled debt restructures 2 loans with post-modification balances totaling $2,693. Please refer to Note 4 for information on troubled debt restructurings.

Net Interest Income

The net interest income analysis for the three and nine months ended September 30, 2015 and 2014 follows:

	Three Months Ended September 30, 2015				**September 30, 2014**			
	Average Balance	**Interest**	**Average Yield/ Rate**		**Average Balance**	**Interest**	**Average Yield/ Rate**	
Interest-earning assets:								
Loans, net (1)(2)(3)(4)	**$627,734**	**$7,855**	**4.96**	**%**	$592,724	$7,861	5.26	%
Taxable securities (5)	**229,887**	**1,678**	**2.90**	**%**	220,090	1,718	3.10	%
Nontaxable securities (1)(5)(6)	**147,300**	**2,095**	**5.64**	**%**	155,420	2,223	5.67	%
Interest-bearing deposits	**84,882**	**54**	**0.25**	**%**	100,349	64	0.25	%
Total interest-earning assets	**$1,089,803**	**$11,682**	**4.25**	**%**	$1,068,583	$11,866	4.41	%
Interest-bearing liabilities:								
Interest-bearing demand deposits	**$518,881**	**$699**	**0.53**	**%**	$501,995	$778	0.61	%
Savings deposits	**86,701**	**9**	**0.04**	**%**	79,001	8	0.04	%
Time deposits	**200,073**	**301**	**0.60**	**%**	227,079	361	0.63	%
Total interest-bearing liabilities	**$805,655**	**$1,009**	**0.50**	**%**	$808,075	$1,147	0.56	%
Net interest income and interest rate spread		**$10,673**	**3.75**	**%**		$10,719	3.85	%
Net yield on average interest-earning assets			**3.89**	**%**			3.98	%

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the nine-month periods presented.

(2) Included in interest income are loan fees of $117 and $111 for the three months ended September 30, 2015 and 2014, respectively.

(3) Nonaccrual loans are included in average balances for yield computations.

(4) Includes mortgage loans held for sale.

(5) Daily averages are shown at amortized cost.

(6) Includes restricted stock.

	Nine Months Ended September 30, 2015				September 30, 2014			
	Average Balance	Interest	Average Yield/ Rate		Average Balance	Interest	Average Yield/ Rate	
Interest-earning assets:								
Loans, net (1)(2)(3)(4)	**$619,142**	**$23,387**	**5.05**	**%**	$591,995	$23,807	5.38	%
Taxable securities (5)	**234,303**	**5,124**	**2.92**	**%**	213,238	5,068	3.18	%
Nontaxable securities (1)(5)(6)	**148,463**	**6,344**	**5.71**	**%**	158,890	6,828	5.75	%
Interest-bearing deposits	**91,791**	**173**	**0.25**	**%**	101,908	193	0.25	%
Total interest-earning assets	**$1,093,699**	**$35,028**	**4.28**	**%**	$1,066,031	$35,896	4.50	%
Interest-bearing liabilities:								
Interest-bearing demand deposits	**$522,300**	**$2,178**	**0.56**	**%**	$499,064	$2,598	0.70	%
Savings deposits	**85,366**	**26**	**0.04**	**%**	78,013	26	0.04	%
Time deposits	**207,134**	**943**	**0.61**	**%**	233,731	1,133	0.65	%
Total interest-bearing liabilities	**$814,800**	**$3,147**	**0.52**	**%**	$810,808	$3,757	0.62	%
Net interest income and interest rate spread		**$31,881**	**3.76**	**%**		$32,139	3.88	%
Net yield on average interest-earning assets			**3.90**	**%**			4.03	%

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the nine-month periods presented.

(2) Included in interest income are loan fees of $353 and $310 for the nine months ended September 30, 2015 and 2014, respectively.

(3) Nonaccrual loans are included in average balances for yield computations.

(4) Includes mortgage loans held for sale.

(5) Daily averages are shown at amortized cost.

(6) Includes restricted stock.

The net interest margin decreased 9 basis points for the three-month period and 13 basis points for the nine-month period ended September 30, 2015, when compared with the three and nine month periods ended September 30, 2014, respectively. The decrease in interest rate spread was driven by a decline in the yield on earning assets of 16 basis points for the three-month period and 22 basis points for the nine-month period, offset by a decline in the cost of interest-bearing liabilities of 6 basis points for the three-month period and 10 basis points for the nine-month period.

Loans and securities experienced a decline in yields. The 30 basis point decline on loans for the three-month period and 33 basis point decline for the nine-month period stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The yield on taxable securities was 20 basis points lower for the three months ended September 30, 2015 and 26 basis points lower for the nine months ended September 30, 2015, when compared with the same periods in 2014. The yield on nontaxable securities declined 3 basis points over the three-month period and 4 basis points over the 9 month period ended September 30, 2015. The market yield for securities of a comparable term has declined over the past year, causing matured and called bonds to be replaced with lower yielding investments.

For the three-month and nine-month periods ended September 30, 2015, the decline in the cost of interest-bearing liabilities came mainly from a 3 and 4 basis point, respectively, reduction in the cost of time deposits and an 8 and 14 basis point, respectively, reduction in interest-bearing demand deposits when compared with the three-month and

nine-month periods ended September 30, 2014. The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment.

Provision and Allowance for Loan Losses

The provision for loan losses for the three-month and nine- month periods ended September 30, 2015 was $178 and $734, respectively, compared with $356 and $1,160 for the three and nine months, respectively, ended September 30, 2014. The provision for loan losses is the result of a detailed analysis to estimate an adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at September 30, 2015 was 1.30%, which compares to 1.36% at December 31, 2014. The net charge-off ratio was 0.19% for the nine months ended September 30, 2015 and 0.27% for the year ended December 31, 2014. See “Asset Quality” for additional information.

Noninterest Income

	Three Months Ended September 30, 2015	**September 30, 2014**	**Percent Change**
Service charges on deposits	**$571**	$ 634	**(9.94)%**
Other service charges and fees	**45**	42	**7.14%**
Credit card fees	**972**	929	**4.63%**
Trust fees	**314**	296	**6.08%**
BOLI income	**151**	153	**(1.31)%**
Other income	**234**	200	**17.00%**
Realized securities gains, net	**2**	4	**(50.00)%**

	Nine Months Ended September 30, 2015	**September 30, 2014**	**Percent Change**
Service charges on deposits	**$1,676**	$ 1,833	**(8.57)%**
Other service charges and fees	**164**	145	**13.10%**
Credit card fees	**2,843**	2,687	**5.81%**
Trust fees	**902**	921	**(2.06)%**
BOLI income	**451**	462	**(2.38)%**
Other income	**977**	783	**24.78%**
Realized securities gains, net	**5**	5	**---**

Service charges on deposit accounts for the three-month and nine-month periods ended September 30, 2015 decreased when compared with the same periods in 2014, while other service charges and fees increased. Other service charges and fees includes charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees

for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Service charges on deposits and other service charges and fees are subject to normal business fluctuation and are not due to changes in fee structure.

Credit card fees for the three-month and nine-month periods ended September 30, 2015 increased 4.63% and 5.81%, respectively, when compared with the same periods last year. The increase stemmed from a change in vendors that resulted in more favorable fee income, as well as a higher volume of merchant transactions and credit card fees.

Income from trust fees increased $18 or 6.08% for the three months ended September 30, 2015, compared with the three months ended September 30, 2014. For the nine-month periods ended September 30, 2015 and 2014, trust income declined $19 or 2.06%. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income decreased slightly for both the three-month and nine-month periods ended September 30, 2015, when compared to the same periods in 2014.

Other income includes fees on the sale of secondary-market mortgages, net gains from the sales of fixed assets, revenue from investment and insurance sales and other smaller miscellaneous components. Other income for the three-month and nine-month periods ended September 30, 2015 increased $34 and $194, respectively, when compared with the same periods ended September 30, 2014. Fees on the sale of secondary-market mortgages increased from the three-month and nine-month periods ended September 30, 2014 by $45 and $80, respectively. Other income in 2015 also benefitted from a vendor signing incentive. These areas fluctuate with market conditions and because of competitive factors.

Net realized securities gains for the three and nine months ended September 30, 2015 were $2 and $5, respectively, compared with a gains of $4 and $5 for the same periods in 2014. Net realized securities gains and losses are market driven and have resulted from calls and sales of securities.

Noninterest Expense

	Three Months Ended September 30, 2015	September 30, 2014	Percent Change
Salaries and employee benefits	**$3,149**	$ 2,927	**7.58 %**
Occupancy, furniture and fixtures	**436**	403	**8.19 %**
Data processing and ATM	**384**	429	**(10.49)%**
FDIC assessment	**138**	147	**(6.12)%**
Credit card processing	**701**	673	**4.16 %**
Intangibles amortization	**269**	269	**---**
Net costs of other real estate owned	**52**	98	**(46.94)%**
Franchise taxes	**329**	307	**7.17 %**
Other operating expenses	**864**	862	**0.23 %**

	Nine Months Ended September 30, 2015	September 30, 2014	Percent Change
Salaries and employee benefits	**$9,433**	$ 8,890	**6.11 %**
Occupancy, furniture and fixtures	**1,296**	1,250	**3.68 %**
Data processing and ATM	**1,230**	1,189	**3.45 %**
FDIC assessment	**408**	411	**(0.73)%**
Credit card processing	**1,986**	1,887	**5.25 %**
Intangibles amortization	**807**	807	**---**
Net costs of other real estate owned	**569**	259	**119.69 %**
Franchise taxes	**959**	874	**9.73 %**
Other operating expenses	**2,690**	2,747	**(2.07)%**

Total noninterest expense increased $207 or 3.39% when the three months ended September 30, 2015 are compared to the same period of 2014, and increased $1,064 or 5.81% when the nine month periods ended September 30, 2015 and September 30, 2014 are compared. For the three-month and nine-month periods, salaries and employee benefits accounted for the largest increase, rising $222 or 7.58% when the three-month periods are compared, and $543 or 6.11% when the nine-month periods are compared. An increase of $310 or 119.69% in net costs of other real estate owned also contributed to the rise in noninterest expense for the nine-months ended September 30, 2015, compared with the nine months ended September 30, 2014. Changing conditions in the real estate market and the resulting change in property appraisals caused the OREO write downs. The cost of other real estate owned includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market.

Noninterest expense categories that increased from 2014 include occupancy, furniture and fixtures, credit card processing, and franchise taxes. Occupancy, furniture and fixtures expense for the three and nine months ended September 30, 2015 increased $33 and $46, respectively, as the result of normal business expenditures. Credit card processing costs increased $28 and $99 for the three and nine months ended September 30, 2015 when compared with the same periods of 2014. This expense is driven by volume and other factors and is subject to a degree of variability. Franchise tax expense increased $22 for the three months ended September 30, 2015 and $85 for the nine-month period ended September 31, 2015, compared with the same periods of 2014. Franchise tax is based on capital levels of the subsidiary bank.

Data processing and ATM expense for the three-month period ended September 30, 2015 declined $45 when compared with the three months ended September 30, 2014, but increased $41 when the nine-month periods ended September 30, 2015 and 2014 are compared. The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the past year, with no change in expense between the three and nine month periods ended September 30, 2015 and September 30, 2014.

FDIC assessment expense for the three months ended September 30, 2015 declined $9 when the three-months ended September 2015 are compared with the same period of 2014. When the nine month periods ended September 30, 2015 and 2014 are compared, the expense declined $3 or 0.73%. The calculation is based on total assets and incorporates risk-based factors to determine the amount of the assessment.

Other operating expense increased slightly for the three month period ended September 30, 2015, compared with the same period of 2014. For the nine months ended September 30, 2015, other operating expense decreased $57 or 2.07% when compared with the same period of 2014. The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations and other expenses.

Balance Sheet

Year-to-date daily averages for the major balance sheet categories are as follows:

Assets	September 30, 2015	December 31, 2014	Percent Change
Interest-bearing deposits	**$91,791**	$103,320	**(11.16)%**
Securities available for sale and restricted stock	**223,941**	198,122	**13.03%**
Securities held to maturity	**156,678**	162,906	**(3.82)%**
Loans, net	**610,135**	592,944	**2.90%**
Total assets	**1,150,026**	1,120,848	**2.60%**
Liabilities and stockholders' equity			
Noninterest-bearing demand deposits	**$157,304**	$146,532	**7.35%**
Interest-bearing demand deposits	**522,300**	501,956	**4.05%**
Savings deposits	**85,366**	78,778	**8.36%**
Time deposits	**207,134**	230,418	**(10.11)%**
Stockholders' equity	**170,883**	157,832	**8.27%**

Securities

Management regularly monitors the quality of the securities portfolio, and management closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 5: Securities for additional information.

Loans

	September 30, 2015	December 31, 2014	Percent Change
Real estate construction loans	**$44,886**	$45,562	**(1.48)%**
Consumer real estate loans	**144,990**	147,039	**(1.39)%**
Commercial real estate loans	**315,008**	310,762	**1.37%**
Commercial non real estate loans	**39,255**	33,413	**17.48%**
Public sector and IDA	**52,330**	41,361	**26.52%**
Consumer non real estate	**30,140**	28,182	**6.95%**
Less: unearned income and deferred fees	**(854)**	(853)	**0.12%**

			)	
Loans, net of unearned income	**$ 625,755**	$ 605,466	**3.35**	**%**

The Company's loans net of unearned income increased by $20,289 or 3.35% from $605,466 at December 31, 2014 to $625,755 at September 30, 2015. Primary drivers of growth were Public Sector and IDA loans which increased $10,969, commercial real estate which increased $4,246 and commercial loans which increased $5,842.

The Company does not now, nor has it ever, offered certain types of higher-risk loans such as subprime loans, option ARM products, reverse mortgages or loans with initial teaser rates.

Deposits

	September 30, 2015	**December 31, 2014**	**Percent Change**	
Noninterest-bearing demand deposits	**$ 163,877**	$ 150,744	**8.71**	**%**
Interest-bearing demand deposits	**514,823**	533,641	**(3.53**	**)%**
Saving deposits	**86,659**	81,297	**6.60**	**%**
Time deposits	**197,171**	216,746	**(9.03**	**)%**
Total deposits	**$ 962,530**	$ 982,428	**(2.03**	**)%**

Total deposits decreased $19,898 or 2.03% from $982,428 at December 31, 2014 to $962,530 at September 30, 2015. Increases in noninterest-bearing demand deposits totaled $13,133 and increases in savings deposits totaled $5,362. These increases were offset by a decline in time deposits of $19,575 and a decline in interest-bearing demand deposits of $18,818, when September 30, 2015 is compared with December 31, 2014. Historically low rates have caused a migration from time deposits to other types of deposits. As longer-term certificates of deposit mature, customers appear unwilling to commit their funds for extended periods at low interest rates. Time deposits do not include any brokered deposits.

Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse sources of liquidity, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank ("FHLB") advances. At September 30, 2015, the bank did not have purchased deposits, discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

Liquidity from securities is restricted by accounting and business considerations. The securities portfolio is segregated into available-for-sale and held-to-maturity. The Company considers only securities designated available-for-sale for typical liquidity needs. Further, portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased or decreased liquidity from public funds deposits or discount window borrowings results in increased or decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and the amount of unpledged available-for-sale securities that are accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to utilize purchased deposits and the Federal Reserve discount window for liquidity needs. At September 30, 2015, the Company is considered well capitalized and does not have any restrictions on purchased deposits or the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At September 30, 2015, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities. It also tests the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At September 30, 2015, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At September 30, 2015, the loan to deposit ratio was 65.01%, within the Company's internal target. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered to account for projected funding

needs.

Capital Resources

Total stockholders' equity at September 30, 2015 was $174,392, an increase of $8,089 or 4.86%, from the $166,303 at December 31, 2014.

Risk based capital ratios are shown in the following table.

	Ratios at September 30, 2015		**Regulatory Capital Minimum Ratios**	
Common Equity Tier I Capital Ratio	**24.38**	**%**	4.50	%
Tier I Capital Ratio	**24.38**	**%**	6.00	%
Total Capital Ratio	**25.50**	**%**	8.00	%
Leverage Ratio	**15.44**	**%**	4.00	%

Effective January 1, 2015 the risk-based capital ratios are calculated in compliance with Federal Reserve rules based on Basel III capital requirements. The Company's ratios are well above the required minimums at September 30, 2015.

Beginning January 1, 2016, a capital conservation buffer of .625% will take effect. The capital conservation buffer will be gradually increased through January 1, 2019 to 2.5%. Banks will be required to maintain capital levels that meet the required minimum plus the capital conservation buffer in order to make distributions or discretionary bonus payments.

Off-Balance Sheet Arrangements

In the normal course of business, NBB extends lines of credit and letters of credit to its customers. Depending on their needs, customers may draw upon lines of credit at any time in any amount up to a pre-approved limit. Standby letters of credit are issued for two purposes. Financial letters of credit guarantee payments to facilitate customer purchases. Performance letters of credit guarantee payment if the customer fails to complete a specific obligation.

Historically, the full approved amount of letters and lines of credit has not been drawn at any one time. The Company has developed plans to meet a sudden and substantial funding demand. These plans include accessing a line of credit with a correspondent bank, borrowing from the FHLB, selling available for sale investments or loans and raising additional deposits.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. Mortgages must meet strict underwriting and documentation requirements for the sale to be completed. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of September 30, 2015. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the nine months ended September 30, 2015, except for normal seasonal fluctuations in the total of mortgage loan commitments.

Contractual Obligations

The Company had no capital lease or purchase obligations and no long-term debt at September 30, 2015. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material at the end of the nine months of 2015 and have not changed materially from those which were disclosed in the Company's 2014 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2014 in the Company's 2014 Form 10-K.

Item 4. Controls and Procedures

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of September 30, 2015 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Because of the inherent limitations in all control systems, the Company believes that no system of controls, no matter how well designed and operated, can provide absolute assurance that all control issues have been detected.

Part II

Other Information

Item 1. Legal Proceedings

There are no pending or threatened legal proceedings to which the Company or any of its subsidiaries is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

Item 1A. Risk Factors

Please refer to the "Risk Factors" previously disclosed in Item 1A of our 2014 Annual Report on Form 10-K and the factors discussed under "Cautionary Statement Regarding Forward-Looking Statements" in Part I. Item 2 of this Form

10-Q.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See Index of Exhibits.

Signatures

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

NATIONAL BANKSHARES, INC.

Date: November 5, 2015 /s/ James G. Rakes
James G. Rakes
Chairman, President and

Chief Executive Officer

(Principal Executive Officer)

Date: November 5, 2015 /s/ David K. Skeens
David K. Skeens
Treasurer and

Chief Financial Officer

(Principal Financial Officer)

(Principal Accounting Officer)

Index of Exhibits

Exhibit No.	Description	Page No. in Sequential System
3(i)	Amended and Restated Articles of Incorporation of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	Amended By-laws of National Bankshares, Inc.	(incorporated herein by reference to the Form 8-K filed on July 9, 2014)
4(i)	Specimen copy of certificate for National Bankshares, Inc. common stock	(incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)
*10(i)	National Bankshares, Inc. 1999 Stock Option Plan	(incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on September 4, 1999)
*10(ii)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015)
*10(iii)	Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg	(incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002)
*10(iv)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015)
*10(v)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vi)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)
*10(vii)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(viii)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)
*10(ix)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)
*10(x)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(xi)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on June 12, 2008)

Agreement for F. Brad Denardo

53

*10(xiii)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xii)	Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(xiv)	Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(xv)	Third Amendment, dated January 20, 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(xvi)	Salary Continuation Agreement dated January 20, 2012 between The National Bank of Blacksburg and Bryson J. Hunter	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
31(i)	Section 906 Certification of Chief Executive Officer	(included herewith)
31(ii)	Section 906 Certification of Chief Financial Officer	(included herewith)
32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	(included herewith)
32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	(included herewith)
101	The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended September 30, 2015 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Statements of Income for the three and nine month periods ended September 30, 2015 and 2014; (ii) Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2015 and 2014; (iii)Consolidated Balance Sheets at September 30, 2015 and December 31, 2014; (iv) Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2015; (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014; and (vi) Notes to Consolidated Financial Statements.	

* Indicates a management contract or compensatory plan.