Higher One Holdings, Inc.
Form 10-Q
October 27, 2015
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2015.
or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .
Commission File Number: 001-34779

HIGHER ONE HOLDINGS, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**26-3025501**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

115 Munson Street

New Haven, CT 06511

(Address of Principal Executive Offices)(Zip Code)

(203) 776-7776

(Registrant's Telephone Number, Including Area Code)

N/A

(Former Name, Former Address and Former Fiscal Year, If Changes Since Last Report)

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

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

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

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

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

As of October 23, 2015, there were 47,980,711 shares of common stock, par value $0.001 per share, outstanding.

HIGHER ONE HOLDINGS, INC.

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FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2015

As used herein, the terms "we," "us," "our," "the Company," or "Higher One," unless the context otherwise requires, mean Higher One Holdings, Inc. and its subsidiaries.

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)
Higher One Holdings, Inc.

Condensed Consolidated Balance Sheets

(In thousands of dollars, except share and per share amounts)

(unaudited)

	September 30, 2015	**December 31, 2014**
Assets		
Current assets:		
Cash and cash equivalents	$ 27,785	$ 40,022
Investments in marketable securities	251	249
Accounts receivable	12,581	8,929
Income receivable	8,624	9,053
Deferred tax assets	11,338	3,719
Prepaid expenses and other current assets	5,408	7,805
Total current assets	65,987	69,777
Deferred costs	6,133	4,187
Fixed assets, net	43,374	46,768
Intangible assets, net	51,637	56,255
Goodwill	67,403	67,403
Loan receivable related to New Markets Tax Credit financing	7,633	7,633
Other assets	3,092	2,523
Restricted cash	2,728	2,725
Total assets	$ 247,987	$ 257,271
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,044	$ 3,339
Accrued expenses	50,423	25,872
Deferred revenue	31,930	25,174
Total current liabilities	84,397	54,385
Deferred revenue and other non-current liabilities	4,443	4,019
Loan payable and deferred contribution related to New Markets Tax Credit financing	8,638	8,871
Debt	59,000	94,000
Deferred tax liabilities	961	3,814
Total liabilities	157,439	165,089
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Common stock, $.001 par value; 200,000,000 shares authorized; 59,893,737 shares issued and 47,980,711 shares outstanding at September 30, 2015; 59,570,839 shares issued and	60	60

47,657,813 shares outstanding at December 31, 2014		
Additional paid-in capital	189,746	185,588
Treasury stock, 11,913,026 shares at September 30, 2015 and December 31, 2014	(137,899)	(137,899)
Retained earnings	38,641	44,433
Total stockholders’ equity	90,548	92,182
Total liabilities and stockholders’ equity	$ 247,987	$ 257,271

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

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Higher One Holdings, Inc.

Condensed Consolidated Statements of Operations

(In thousands of dollars, except share and per share amounts)

(unaudited)

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2015	**2014**	**2015**	**2014**
Revenue:				
Account revenue	$26,654	$31,468	$88,523	$99,475
Payment transaction revenue	19,055	18,197	47,497	42,652
Higher education institution revenue	10,486	9,929	30,891	28,958
Other revenue	167	181	558	723
Gross revenue	56,362	59,775	167,469	171,808
Less: allowance for customer restitution	(21,880)	-	(21,880)	(8,750)
Revenue	34,482	59,775	145,589	163,058
Cost of revenue	27,817	28,182	77,479	76,878
Gross margin	6,665	31,593	68,110	86,180
Operating expenses:				
General and administrative	18,098	16,617	54,417	48,343
Product development	2,040	1,555	6,120	5,517
Sales and marketing	4,196	4,577	12,638	13,756
Restructuring charge	334	-	574	-
Total operating expenses	24,668	22,749	73,749	67,616
Income (loss) from operations	(18,003)	8,844	(5,639)	18,564
Interest income	23	20	63	73
Interest expense	(1,262)	(828)	(3,894)	(2,443)
Other income (loss)	77	(198)	1,357	1,561
Net income (loss) before income taxes	(19,165)	7,838	(8,113)	17,755
Income tax expense (benefit)	(6,510)	2,922	(2,321)	6,900
Net income (loss)	$(12,655)	$4,916	$(5,792)	$10,855
Net income (loss) available to common stockholders:				
Basic	$(12,655)	$4,916	$(5,792)	$10,855
Diluted	$(12,655)	$4,916	$(5,792)	$10,855
Weighted average shares outstanding:				
Basic	47,783,217	47,258,495	47,605,164	47,180,830
Diluted	47,783,217	47,710,262	47,605,164	48,104,873
Net income (loss) available to common stockholders per common share:				
Basic	$(0.26)	$0.10	$(0.12)	$0.23
Diluted	$(0.26)	$0.10	$(0.12)	$0.23

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

Higher One Holdings, Inc.

Condensed Consolidated Statement of Changes in Stockholders' Equity

(In thousands of dollars, except share amounts)

(unaudited)

	Common Stock Shares	Amount	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Total Stockholders' Equity
Balance at December 31, 2014	47,657,813	$ 60	$ 185,588	$ (137,899)	$ 44,433	$ 92,182
Stock-based compensation	-	-	4,928	-	-	4,928
Reversal of tax benefit related to options	-	-	(1,115)	-	-	(1,115)
Exercise of stock options	322,898	-	345	-	-	345
Net income	-	-	-	-	(5,792)	(5,792)
Balance at September 30, 2015	47,980,711	$ 60	$ 189,746	$ (137,899)	$ 38,641	$ 90,548

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

Higher One Holdings, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands of dollars)

(unaudited)

	Nine Months Ended September 30, 2015			2014		
Cash flows from operating activities						
Net income (loss)	$	(5,792	)	$	10,855	
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization		16,429			14,124	
Amortization of deferred finance costs		1,657			368	
Stock-based compensation		4,877			3,426	
Deferred income taxes		(11,569	)		810	
Income tax benefit related to exercise of stock options		(120	)		(47	)
Other (income) loss		(236	)		42	
Loss on disposal of fixed assets		118			90	
Changes in operating assets and liabilities:						
Accounts receivable		(3,652	)		(3,235	)
Income receivable		429			(5,087	)
Deferred costs		(396	)		(2,103	)
Prepaid expenses and other current assets		2,397			(2,051	)
Other assets		(569	)		(91	)
Accounts payable		(1,295	)		(1,636	)
Accrued expenses		24,245			(1,713	)
Deferred revenue		6,412			7,151	
Net cash provided by operating activities		32,935			20,903	

Cash flows from investing activities						
Purchases of fixed assets		(2,471	)		(2,858	)
Additions to internal use software		(3,699	)		(4,173	)
Amounts received from restricted cash		-			25	
Proceeds from disposition of equity method investment		-			3,581	
Proceeds from development related subsidies		-			3,468	
Net cash provided by (used in) investing activities		(6,170	)		43	
Cash flows from financing activities						
Proceeds from line of credit		-			15,000	
Repayments of line of credit		(35,000	)		(10,000	)
Payment of deferred financing costs		(4,467	)		-	
Tax benefit related to exercise of stock options		120			47	
Proceeds from exercise of stock options		345			184	
Net cash provided by (used in) financing activities		(39,002	)		5,231	
Net change in cash and cash equivalents		(12,237	)		26,177	
Cash and cash equivalents at beginning of period		40,022			6,268	
Cash and cash equivalents at end of period	$	27,785		$	32,445	

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

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Nature of Business and Organization

Higher One Holdings, Inc., or HOH, is a leading provider of technology, data analytics and payment services to the higher education industry. HOH, through its subsidiaries, provides a comprehensive suite of disbursement, payment and data analytics solutions specifically designed for higher education institutions and their students. We have developed and acquired proprietary software-based solutions to provide these services. HOH is incorporated in Delaware and maintains its headquarters in New Haven, Connecticut. HOH has a wholly-owned subsidiary, Higher One, Inc., or HOI, which has two wholly-owned subsidiaries, Higher One Machines, Inc., or HOMI, and Higher One Real Estate, Inc., or Real Estate Inc. HOI and HOMI together own 99.99% of Higher One Financial Technology Private Limited, or HOFTPL. Real Estate Inc. has a 98% ownership interest in Higher One Real Estate SP, LLC, or Real Estate LLC. HOMI and HOFTPL perform certain of our operational support functions. Real Estate Inc. and Real Estate LLC were each formed to hold and operate certain of our real estate.

2. Significant Accounting Policies

Basis of Presentation and Consolidation

The accompanying unaudited condensed consolidated financial statements and the related interim information contained within the notes to such condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, and the applicable rules of the Securities and Exchange Commission, or the SEC, for interim information and quarterly reports on Form 10-Q.

The unaudited condensed consolidated financial statements have been prepared on a consistent basis with the audited consolidated financial statements included in our annual report on Form 10-K for the year ended December 31, 2014, and in the opinion of management, include all normal recurring adjustments that are necessary for the statement of our interim period results reported herein. The December 31, 2014 condensed consolidated balance sheet data included in this Form 10-Q was derived from our audited financial statements but does not include all disclosures required by GAAP. Due to seasonal fluctuations and other factors, the results of operations for the three or nine months ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year.

The unaudited condensed consolidated financial statements reflect our financial position and results of operations, including our majority and wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make significant estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could materially differ from management's estimates.

Goodwill and Intangible Assets

Goodwill represents the excess of the fair value of consideration transferred over the fair values assigned to the underlying net identifiable assets of acquired businesses. We test goodwill for impairment annually on October 31, or whenever events or changes in circumstances indicate that impairment may have occurred, by comparing its fair value to its carrying value. Impairment may result from, among other things, deterioration in the performance of an acquired business, adverse market conditions, adverse changes in applicable laws or regulations, including changes that restrict the activities of an acquired business, and a variety of other circumstances.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

As further described in Note 7, we have three reportable segments: Disbursements, Payments and Data Analytics, which are organized according to the type of service that each offers to our target markets – higher education institutions and their students. Each of these business units is also an operating segment and a reporting unit for purposes of our goodwill impairment testing. The excess of fair value over carrying value varies by reporting unit. The fair value of the disbursements reporting unit exceeded its carrying value by approximately 40% as of March 31, 2015 and is the reporting unit most susceptible to impairment in the future. As further described in Note 9, on October 14, 2015, we entered into an asset purchase agreement for the sale of substantially all of the assets of our data analytics business.

Income Taxes

On June 30, 2015, the state of Connecticut enacted changes to its corporate tax laws, including a mandatory unitary tax filing requirement for all Connecticut companies effective January 1, 2016. As a result of the tax law changes, it is now more likely than not that we will utilize certain net operating loss carry forwards for which we previously had recorded a valuation allowance. We have recorded an income tax benefit of approximately $0.3 million during the nine months ended September 30, 2015 due to the tax law changes.

The effective tax rates for the nine months ended September 30, 2015 and 2014 were 28.6% and 38.9%, respectively. Our effective tax rate decreased from the prior year primarily as a result of the allowance for customer restitution described in Note 6, which results in a pretax loss, the tax benefit on which is diminished by permanent differences between book and tax income.

Basic and Diluted Net Income (Loss) Available to Common Stockholders per Common Share

Basic net income (loss) per common share excludes dilution for potential common stock issuances and is computed by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the reporting period. Diluted net income (loss) per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted net income (loss) per common share, the basic weighted-average number of shares is increased by the dilutive effect of restricted stock, warrants and stock options using the treasury-stock method. The treasury-stock method assumes that the options or warrants are exercised at the beginning of the period (or date of issue, if later), and that we use those proceeds to purchase common stock for treasury at the average price for the reporting period.

The effect of stock options and warrants to purchase our common stock totaling 6,211,240 and 6,223,862 were not included in the computation of diluted net income (loss) per common share for the three months ended September 30, 2015 and 2014, respectively, as their effect would be anti-dilutive. The effect of stock options and warrants to purchase our common stock totaling 6,211,240 and 4,214,539 were not included in the computation of diluted net income (loss) per common share for the nine months ended September 30, 2015 and 2014, respectively, as their effect would be anti-dilutive. Anti-dilutive securities are securities that upon conversion or exercise increase earnings per share (or reduce the loss per share). In periods when we recognize a net loss, we exclude the impact of outstanding stock awards from the diluted loss per share calculation as their inclusion would have an anti-dilutive effect.

Comprehensive Income (Loss)

There are no comprehensive income (loss) items other than net income (loss). There are no recorded unrealized gains or losses on the investments in marketable securities as of the balance sheet dates. Comprehensive income equals net income for all periods presented.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

Other Arrangements

We accept payments on behalf of educational institutions and subsequently remit these payments to the education institutions. The amounts received are maintained in segregated accounts for the benefit of either the institution or the payer. There were approximately $256.2 million and $127.3 million of such funds as of September 30, 2015 and December 31, 2014, respectively. These deposits are not our funds and therefore are not included in the accompanying condensed consolidated balance sheets.

Recent Accounting Pronouncements

There were no accounting standards adopted during the nine months ended September 30, 2015 which had a material impact on our consolidated financial position, results of operations or liquidity.

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2014-09, *Revenue From Contracts With Customers*, that outlines a single model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance. The ASU is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. Entities have the option of using either a full retrospective or a modified retrospective approach for the adoption of the new standard. This standard will be effective for fiscal periods beginning after December 15, 2017; early adoption will be permitted, but not earlier than fiscal periods beginning after December 15, 2016. We are currently assessing the impact that this standard will have on our consolidated financial statements.

In June 2014, the FASB issued Accounting Standards Update No. 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*, which updated the accounting standards related to stock compensation. The update clarifies the accounting for share-based payments with a performance target that could be achieved after the requisite service period. Specifically, the update specifies that the performance target should not be reflected in estimating the grant-date fair value of the award. Instead, the probability of achieving the performance target should impact vesting of the award. The standard will be effective for interim and annual periods beginning after December 15, 2015 and early adoption is permitted. We do not expect the adoption of this standard to have a significant impact on our consolidated financial statements or disclosures.

In April 2015, the FASB issued Accounting Standard Update No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs,* which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the associated debt liability. In August 2015, the FASB issued Accounting Standards Update No. 2015-15, "*Interest – Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements,*" which provides additional guidance to ASU No. 2015-03, which did not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. ASU 2015-15 noted that the SEC staff 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. This standard will be effective for fiscal periods beginning after December 15, 2015 and early adoption is permitted. We do not believe this standard will have a significant impact on our consolidated financial statements or disclosures.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

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3. Investments in Marketable Securities and Fair Value Measurements

The following table reflects the assets carried at fair value measured on a recurring basis (in thousands). There were no liabilities carried at fair value measured on a recurring basis at either September 30, 2015 or December 31, 2014:

	Total	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Unobservable Inputs (Level 3)**
Fair values at September 30, 2015				
Assets:				
Certificate of deposit	$ 251	$ -	$ 251	$ -
Fair values at December 31, 2014				
Assets:				
Certificate of deposit	$ 249	$ -	$ 249	$ -

We had no unrealized gains or losses from investments as of September 30, 2015 or December 31, 2014, and there is no material difference between the amortized cost and fair value of the securities we held. The carrying amounts of our cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value because of the short-term nature of these instruments. The carrying amount of our debt outstanding under our Credit Facility (defined in Note 5 below) approximates fair value as a result of our amendment to the credit facility in February 2015. Our loan receivable related to our New Markets Tax Credit financing is a debt instrument that we classify as held to maturity and is recorded at amortized cost. The carrying value of both our loan receivable and loan payable related to our New Markets Tax Credit financing approximates fair value as of September 30, 2015. The fair value of our loan payable and loan receivable related to our New Markets Tax Credit financing was estimated using discounted cash flow analysis based on rates for similar types of arrangements and are considered Level 3 measurements.

4. Real Estate Development Project

At the end of 2011, we completed a real estate development project and moved our headquarters into two commercial buildings located in New Haven, Connecticut. During the nine months ended September 30, 2014, we received a payment of $3.5 million associated with state historic tax credits which were generated by the project.

In connection with the project, we provided separate guarantees to each of two departments of the state of Connecticut. One guaranty relates to our obligation to repay a grant if we fail to meet certain criteria, including a specified minimum average employment level in Connecticut for the years 2015 – 2018. The other guaranty relates to our obligation to repay sales and use tax exemptions if we fail to meet certain criteria, including a minimum employment threshold. The maximum potential amount of repayments for these guarantees is approximately $7.0 million. As of September 30, 2015, we have a liability of $2.0 million recorded which represents our best estimate of expected repayments resulting from these guarantees. A portion of the liability ($1.8 million) is recorded within deferred revenue and other non-current liabilities as it would not be due until 2019 and the remaining balance ($0.2 million) is recorded in accrued expenses in our condensed consolidated balance sheets as of both September 30, 2015 and December 31, 2014.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

We also provided a guaranty related to tax credits that are expected to be generated by an investment made by an unrelated entity into the real estate development project. In the event that we cause a recapture or disallowance of the tax credits expected to be generated under this program, we will be required to repay the disallowed or recaptured tax credits plus an amount sufficient to pay the taxes on such repayment, to the counterparty of the guaranty agreement. This guaranty will remain in place through 2018. The maximum potential amount of future payments under this guaranty is approximately $6.0 million. We currently believe that the requirement to make a payment under this guaranty is remote and we have thus not recorded any liability on our condensed consolidated balance sheet in connection with this guaranty.

5. Credit Facility

In October 2012, HOI entered into a five-year, $200.0 million, senior secured revolving credit facility, or the Credit Facility. The Credit Facility contains certain affirmative covenants, including covenants to furnish the lenders with financial statements and other financial information and to provide the lenders notice of material events and information regarding collateral. The Credit Facility also contains certain negative covenants that, among other things, restrict our ability, subject to certain exceptions, to incur additional indebtedness, grant liens on our assets, undergo fundamental changes, make investments, sell assets, make restricted payments, change the nature of our business and engage in transactions with our affiliates. The maturity of the Credit Facility could be accelerated upon a change of control or if we experience a material adverse change in our operations, condition or prospects.

We amended the Credit Facility in February 2015, which modified certain of the financial covenants and other terms of the agreement as follows:

the revolving credit facility was reduced to $140.0 million, with $35.0 million of such facility reserved only for the resolution of the certain regulatory matters, as defined. The revolving credit facility subsequently reduces to $130.0 million and $120.0 million as of December 31, 2015 and 2016, respectively;

requires us to maintain a debt to consolidated EBITDA ratio, or leverage ratio, of 2.75 to 1.00 or less for the evaluation periods from March 31, 2015 through September 30, 2016, and of 2.50 to 1.00 or less thereafter;

requires us to maintain consolidated EBITDA, as defined in the Credit Facility, as amended, on a consolidated basis for the prior four fiscal quarters of at least the following amounts (i) $45.0 million as of March 31, 2015 and June 30, 2015, (ii) $40.0 million as of September 30, 2015 and December 31, 2015, and (iii) $35.0 million as of March 31, 2016 and all future evaluation periods;

allow, at our option, amounts outstanding under the October 2012 Facility to accrue interest at a rate equal to either (i) the London Interbank Offered Rate, or LIBOR, plus a margin of 4% or (ii) a fluctuating base rate tied to the federal funds rate, the administrative agent's prime rate and LIBOR, plus a margin of 3%;

allow for the payment of up to $75 million related to the settlement of certain regulatory matters, as defined;

allow for the exclusion from the computation of consolidated EBITDA of up to $75.0 million of income statement charges related to certain regulatory matters, as defined; and

automatically and permanently reduce the revolving credit facility, dollar for dollar up to a maximum reduction in the revolving credit facility of $20.0 million, to the extent that the loss related to those certain regulatory matters is less than $70.0 million.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

We also amended the Credit Facility in June 2015. Under the Credit Facility, as constituted prior to the effectiveness of the June 2015 amendment, if more than half of the incumbent board of directors was replaced in any twelve month period through a contested election or threatened contested election, the lenders were entitled to declare a default and cause the principal and any accrued interest on any outstanding loans to become immediately due and payable. This type of provision is sometimes referred to as a Dead Hand Proxy Put. The June 2015 amendment removes the Dead Hand Proxy Put from the Credit Facility by amending the definition of Change of Control.

We further amended the Credit Facility in October 2015, which modified certain of the financial covenants and other terms of the agreement as follows:

allows for the sale of substantially all of the assets of the Campus Labs business, as further described in Note 9 and requires us to pay down outstanding loans under the Credit Facility by an amount equal to $30.0 million upon the sale of the Campus Labs business;

the revolving credit facility was reduced to $75.0 million, with $35.0 million of such facility reserved only for the resolution of the certain regulatory matters, as defined. The revolving credit facility subsequently reduces to $65.0 million and $55.0 million as of June 30, 2016 and December 31, 2016, respectively;

requires us to maintain a debt to consolidated EBITDA ratio, or leverage ratio, of 2.00 to 1.00 or less as of December 31, 2015 and all future evaluation periods;

requires us to maintain consolidated EBITDA, as defined in the Credit Facility, as amended, on a consolidated basis for the prior four fiscal quarters of at least $25.0 million as of December 31, 2015 and all future evaluation periods; and

automatically and permanently reduce the revolving credit facility, dollar for dollar up to a maximum reduction in the revolving credit facility of $20.0 million, to the extent that the loss related to those certain regulatory matters is less than $70.0 million.

The Credit Facility permits the issuance of letters of credit of up to $20.0 million and swing line loans of up to $10.0 million to fund working capital needs. Loans drawn under the Credit Facility are payable in a single maturity on

October 16, 2017. In connection with the February 2015 amendment, we paid down the outstanding balance of the Credit Facility by $35 million, expensed approximately $0.4 million of previously deferred financing costs and incurred new financing costs of approximately $4.5 million in February 2015, which are included in deferred costs as of September 30, 2015 in the accompanying condensed consolidated balance sheet.

As of September 30, 2015, there were $59.0 million in borrowings outstanding, at a weighted average interest rate of 4.2%, under the Credit Facility. We are in compliance with all of the applicable affirmative, negative and financial covenants of the Credit Facility. As of September 30, 2015, our trailing twelve month consolidated EBITDA (as defined in the Credit Facility) was $53.7 million.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

6. Commitments and Contingencies

From time to time we are subject to litigation relating to matters in the ordinary course of business, as well as regulatory examinations, information gathering requests, inquiries and investigations. In accordance with applicable accounting guidance, we establish a liability for a matter of the type described below if and when it presents loss contingencies that are both probable and reasonably estimable.

Department of Education

In early 2014, the Department of Education, or ED, formed a negotiated rulemaking committee to discuss and work toward revising existing regulations to potentially address, among other things, consumer safeguards regarding debit and prepaid cards associated with Title IV Cash Management, marketing of financial products by institutions and their preferred banks or contractors, ATM access and availability, revenue sharing arrangements, and the potential for a government-sponsored debit or prepaid card solution. On May 18, 2015, ED published its Notice of Proposed Rulemaking, or NPRM, on program integrity and improvement issues in the Federal Register. ED may publish these proposed rules in their current form or in a different form that may be more adverse to our business. Any rules substantially similar to those proposed could have a material adverse effect on our business. Should ED publish final rules in the Federal Register by November 1, 2015, we believe new Title IV Cash Management regulations would likely not go into effect until July 1, 2016.

Regulatory Examinations and Other Matters

On May 9, 2014, the Federal Reserve Banks of Chicago (the responsible Reserve Bank for a former bank partner) and Philadelphia (the responsible Reserve Bank for a current bank partner) notified us that the Staff of the Board of Governors of the Federal Reserve System intended to recommend that the Board of Governors of the Federal Reserve System, or the Board of Governors, seek an administrative order against us with respect to asserted violations of the Federal Trade Commission Act. The cited violations relate to our activities with both a former and current bank partner and our marketing and disclosure practices related to the process by which students may select the OneAccount option for financial aid refund. On September 24, 2015, the Staff of the Board of Governors of the Federal Reserve System provided a revised notification to us with respect to those asserted violations of the Federal Trade Commission Act. We are in discussions with the Staff of the Board of Governors and the Reserve Banks on this matter. The Staff of the Board of Governors has asserted that any administrative order may seek damages, including customer restitution and civil money penalties and changes to certain of our business practices.

In April 2015, the San Francisco Regional Office of the FDIC (the responsible Regional Office for a current bank partner) notified us it was prepared to recommend to the Director of the Division of Depositor and Consumer Protection that administrative enforcement action be taken against us for alleged violations of the Federal Trade Commission Act principally relating to our marketing and enrollment practices related to the OneAccount. We have responded to the FDIC's notification and we believe that these allegations are similar and related to the Federal Reserve Board allegations previously disclosed and discussed above. On September 24, 2015, the San Francisco Regional Office of the FDIC provided a revised notification to us regarding those alleged violations of the Federal Trade Commission Act. Any such enforcement action could result in orders to pay restitution and civil money penalties and changes to certain of our business practices.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

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During the year ended December 31, 2014, we recorded a liability of $8.75 million related to these matters. The liability, which continued to be recorded at $8.75 million through June 30, 2015, reflected the minimum amount we expected to pay related to these matters. During the three months ended September 30, 2015, we recorded an additional charge of $21.9 million related to these matters, bringing the total liability to $30.6 million, as a result of an updated assessment of the minimum amount we expect to pay related to these matters. Each of these amounts is shown as an allowance for customer restitution on our condensed consolidated statement of operations in the period in which the charge was incurred and is related to our disbursements segment. The total liability of $30.6 million is recorded within accrued expenses on our condensed consolidated balance sheets. While we believe that it is probable that we will have a loss related to these regulatory matters, in view of the inherent difficulty of predicting the outcomes of regulatory matters, we cannot predict the eventual outcomes of these pending matters, the timing of the ultimate resolution of these matters or an exact amount of loss associated with these matters. The liability recorded at September 30, 2015, reflects the minimum amount we expect to pay related to these matters, although there is a reasonable possibility that the liability will increase in future periods. The ultimate amount of restitution or civil money penalties is subject to many uncertainties and therefore impossible to predict, however we believe our exposure related to these matters is approximately $70.0 million in total. As disclosed in “Note 5 – Credit Facility” of our condensed consolidated financial statements, we amended our Credit Facility in February 2015. The amendment allows, among other things, for the payment of up to $75.0 million in connection with the resolution of the regulatory matters described above.

In July 2014, we received a civil investigative demand from the Office of the Attorney General of the Commonwealth of Massachusetts pursuant to the Commonwealth’s Consumer Protection Act. The Massachusetts Attorney General has informed us that its investigation relates to our debt collection practices. We have provided information requested by the civil investigative demand, which included information and records about us and certain of our business practices, particularly as they relate to Massachusetts residents, institutes of higher education and students. We cannot predict whether we will become subject to any other action by the Massachusetts Attorney General or any other state agencies.

Consumer Class Action

HOI and HOH were defendants in a series of putative class action lawsuits filed in 2012. The Judicial Panel on Multidistrict Litigation transferred all of these cases to the District of Connecticut for coordinated or consolidated pretrial proceedings. The proceedings are referred to as the “In re Higher One OneAccount Marketing and Sales Practices Litigation” or the MDL. Plaintiffs filed a consolidated amended complaint in the MDL that generally alleged, among other things, violations of state consumer protection statutes (predicated, in part, on alleged violations of rules of the federal Department of Education, or ED, and violations of the federal Electronic Funds Transfer Act) and various common law claims.

In October 2013, we reached an agreement in principle on the key terms of a settlement that would resolve all of the above class action litigation that was filed against us in 2012. In February 2014, we executed a settlement agreement, the terms of which included a payment of $15.0 million to a settlement fund, an agreement to pay the cost of notice to the class, and an agreement to make and/or maintain certain practice changes. We made the payment of $15.0 million to the settlement fund in February 2014. On December 15, 2014, the Court granted final approval of the settlement. No appeals of the judgment were filed, and the settlement has now become final.

During the year ended December 31, 2013, we recorded an accrual of $16.3 million to reflect the estimated cost of the resolution, inclusive of additional legal and other administrative costs, based on the agreement in principle. This estimate is not materially different than our current cost estimate based on the final, approved settlement agreement.

Securities Class Action

On May 27, 2014, a putative class action captioned Brian Perez v. Higher One Holdings, Inc., No. 3:14-cv-755-AWT, was filed by HOH shareholder Brian Perez in the United States District Court for the District of Connecticut. On December 17, 2014, Mr. Perez was appointed lead plaintiff. On January 20, 2015, Mr. Perez filed an amended complaint. HOH former shareholder Robert Lee was added as a named plaintiff in the amended complaint. HOH and certain employees and board members have been named as defendants. Mr. Perez and Mr. Lee generally allege that HOH and the other named defendants made certain misrepresentations in public filings and other public statements in violation of the federal securities laws and seek an unspecified amount of damages. Mr. Perez and Mr. Lee seek to represent a class of any person who purchased HOH securities between August 7, 2012 and August 6, 2014. All defendants have moved to dismiss the Complaint. In response, Plaintiffs have filed an opposition brief opposing dismissal. HOH intends to vigorously defend itself against these allegations. HOH is currently unable to predict the outcome of this lawsuit and therefore cannot determine the likelihood of loss nor estimate a range of possible loss.

Higher One Holdings, Inc.

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Derivative Actions

On March 6, 2015, HOH shareholder Jason Sabel filed a derivative action in the United States District Court for the District of Connecticut captioned *Jason Sabel, derivatively on behalf of Higher One Holdings, Inc. v. Sheinbaum, et al.,* No. 13:15-cv-00346, against certain of HOH's directors and executive officers and HOH as a nominal defendant. Mr. Sabel is seeking to remedy alleged breaches of certain fiduciary duties by named directors and executive officers that allegedly occurred from approximately February 2014 to the date of the filing. This action relates to the allegations in Perez v. Higher One Holdings, Inc., the securities class action described above. On April 17, 2015, the parties filed a joint motion to stay the action pending the outcome of the motion to dismiss the securities class action.

On May 5, 2015, HOH shareholder Bobby Clay filed a derivative action in the United States District Court for the District of Connecticut captioned *Bobby Clay, derivatively on behalf of Higher One Holdings, Inc. v. Sheinbaum, et al.,* No. 3:15-cv-00666, against certain of HOH's directors and executive officers and HOH as a nominal defendant. Mr. Clay's allegations are substantively the same as those in the *Sabel* case. On July 29, 2015, the cases were consolidated and a motion to stay was granted. HOH is currently unable to predict the outcome of the *Sabel* and *Clay* lawsuits.

Cybersecurity Subpoena

The SEC previously informed us that it opened an investigation on January 20, 2015 into the adequacy of our disclosures of cybersecurity risks. In connection with this investigation into the adequacy of our disclosures, the SEC issued us a subpoena on January 22, 2015 seeking documents related to our cybersecurity, including, among other things, documents related to cybersecurity policies, procedures, practices and training materials; risk assessments, audits, tests or reviews; monetary and other resources allocated to cybersecurity; any cybersecurity incidents and any costs or damages associated with cybersecurity incidents; and insurance policies that cover or mitigate our cybersecurity risk. We are complying with the subpoena and have produced responsive documents to the SEC. We are not aware of any issue or event that caused the SEC to open the investigation, but responding to an investigation of this type can be both costly and time-consuming and at this time we are unable to estimate either the likelihood of a favorable or unfavorable outcome of this matter or our potential cost or exposure.

TouchNet

In February 2009 and September 2010, Higher One, Inc. filed two separate complaints against TouchNet Information Systems, Inc., or TouchNet, in the United States District Court for the District of Connecticut alleging patent infringement related to TouchNet's offering for sale and sales of its "eRefund" product in violation of two of our patents. In the complaints, we sought judgments that TouchNet has infringed two of our patents, a judgment that TouchNet pay damages and interest on damages to compensate us for infringement, an award of our costs in connection with these actions and an injunction barring TouchNet from further infringing our patents. TouchNet answered the complaint and asserted a number of defenses and counterclaims, including that it does not infringe our patent, that our patent is invalid or unenforceable and certain allegations of unfair competition and state and federal antitrust violations. In addition, TouchNet's counterclaims sought dismissal of our claims with prejudice, declaratory judgment that TouchNet does not infringe our patent and that our patent is invalid or unenforceable, as well as an award of fees and costs related to the action, and an injunction permanently enjoining us from suing TouchNet regarding infringement of our patent.

On June 29, 2015, we entered into an agreement with TouchNet, and its successor company Heartland Payment Systems, which resolved our complaints against TouchNet and their counterclaim against us. Pursuant to the terms of the agreement: (i) we were paid $1.1 million, (ii) we provided TouchNet and Heartland Payment Systems a license to use the patents described above, and (iii) both we and TouchNet agreed to dismiss each of our complaints against one another. We recorded the $1.1 million due from TouchNet as other income during the nine months ended September 30, 2015.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

7. Segments

As a result of changes instituted by our chief operating decision maker in 2015, including the type of financial information being reviewed on a regular basis and the way in which resource allocation decisions are made, we now have three reportable segments, Disbursements, Payments and Data Analytics, which are organized according to the type of service that each offers to our target markets – higher education institutions and their students. Each of our reportable segments is also an operating segment and a reporting unit. The Disbursements segment includes our Refund Management® disbursement service, which is offered to higher education institution clients, and the OneAccount, an FDIC-insured online checking account that is offered to students, as well as faculty, staff and alumni. The Payments segment includes our CASHNet® payment processing suite and our Campus Solutions suite, both of which enable higher education institutions to accept online payments, automate certain billing and processing functions and offer tuition payment plans. The Data Analytics segment offers our Campus Labs analytics solutions suite for assessment in higher education, which combine data collection, reporting, organization and campus-wide integration.

We allocate all revenue and all operating expenses to these three reportable segments. Shared costs, such as legal, finance, human resources and other corporate services are allocated in their entirety to the segments. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. Segment assets are not reviewed by the chief operating decision maker and therefore are not allocated to the reportable segments. Segment income from operations excludes interest, taxes, and other income, which are not allocated to any particular business segment.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

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A summary of our segments for the three and nine months ended September 30, 2015 and 2014 is as follows (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2015	**2014**	**2015**	**2014**
Revenue				
Disbursements (1)	$6,314	$33,202	$71,050	$95,083
Payments	23,789	22,889	61,921	57,455
Data Analytics	4,379	3,684	12,618	10,520
Total revenues	$34,482	$59,775	$145,589	$163,058
Depreciation and amortization				
Disbursements	$2,442	$2,224	$7,190	$5,573
Payments	2,311	2,413	6,901	6,793
Data Analytics	810	599	2,338	1,757
Total depreciation and amortization	$5,563	$5,236	$16,429	$14,123
Income (loss) from operations				
Disbursements	$(22,324)	$4,434	$(14,868)	$11,966
Payments	3,795	3,566	7,491	4,868
Data Analytics	526	844	1,738	1,730
Total income (loss) from operations	(18,003)	8,844	(5,639)	18,564
Interest income	23	20	63	73
Interest expense	(1,262)	(828)	(3,894)	(2,443)
Other income	77	(198)	1,357	1,561
Net income (loss) before income taxes	$(19,165)	$7,838	$(8,113)	$17,755

(1) Disbursements revenue has been reduced by $21.9 million for the allowance for potential customer restitution for the three months and nine months ended September 30, 2015, respectively, and by $8.75 million for the nine months ended September 30, 2014.

Higher One Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

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8. Restructuring Charge

In April 2015, we entered into an agreement with a third-party service provider to operate our customer care center in order to provide live-agent, chat and interactive voice response services for our disbursements line of business, including the OneAccount product. In connection with this agreement, we plan to reduce our employee workforce across our customer care department. We began the transition to the third-party service provider in July 2015 and expect to substantially complete the employee reduction by November 2015. However, the timing of this transition and of certain employee reductions may vary. We estimate we will recognize costs of up to $1.0 million during fiscal year 2015, consisting of severance and other employee-related benefits. Such costs are expected to be substantially accrued and paid through the end of the first quarter of 2016.

For the three and nine months ended September 30, 2015 we recognized restructuring charges of $0.3 and $0.6 million, respectively, which is included in restructuring charges in the accompanying condensed consolidated statements of operations.

The restructuring liability is included in accrued expenses as of September 30, 2015. The following table summarizes the activities associated with restructuring liabilities for the nine months ended September 30, 2015.

	Severance and employee-related benefits
January 1, 2015 restructuring liability	$ -
Restructuring charges incurred	574
Amounts paid	(63)
September 30, 2015 restructuring liability	$ 511

9. Subsequent Event - Agreement to Sell Campus Labs Assets

On October 14, 2015, we entered into an Asset Purchase Agreement with CL NewCo, Inc., or NewCo, an affiliate of Leeds Equity Partners, for the sale of substantially all of the assets of our data analytics business, or Campus Labs.

Pursuant to the terms of the Asset Purchase Agreement, NewCo agreed to acquire Campus Labs for a total cash purchase price of approximately $91 million. This purchase price is subject to certain closing adjustments including adjustments for working capital. The working capital adjustments will be determined at the time of closing, but may reduce the purchase price by $5 million to $7 million. The transaction is subject to necessary regulatory approvals and is expected to close by the end of November 2015.

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

The information contained in this section should be read in conjunction with our audited consolidated financial statements and related notes as included in our annual report on Form 10-K for the year ended December 31, 2014 and information contained elsewhere in such annual report on Form 10-K and in this quarterly report on Form 10-Q. The discussion contains forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995) involving risks, uncertainties and assumptions that could cause our results to differ materially from expectations. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects," "should" and similar expressions are intended to identify forward-looking statements. Factors that might cause these differences include those described under "Risk Factors" and elsewhere in the annual report on Form 10-K and in this quarterly report on Form 10-Q. The forward-looking statements included in this quarterly report on Form 10-Q are made only as of the date of this report. We do not undertake any obligation to update or supplement any forward-looking statements to reflect subsequent events or circumstances, except as required by law. We cannot assure you that projected results will be achieved or that anticipated events will occur.

Overview

General

Based on market share and the number of campuses using our products and services, we believe we are a leading provider of technology-based refund disbursement, payment processing and data analytics services to higher education institutions and their students. We believe that none of our competitors match our ability to provide solutions for higher education institutions' financial services needs, including compliance monitoring. Consequently, we provide the most comprehensive suite of disbursement and payment solutions specifically designed for higher education institutions and their students. We also provide campus communities with convenient, cost-competitive and student-oriented banking services, which include extensive user-friendly features.

Our products and services for our higher education institution clients consist of our Disbursement solutions suite, including our Refund Management® disbursement service, our CASHNet® payment processing suite and our Campus Labs® analytics solutions suite. Through our bank partners, we offer the OneAccount, which includes an FDIC-insured checking account, a debit MasterCard® ATM card and other retail banking services, to the students of our higher education institution clients that use our Refund Management disbursement service.

As of September 30, 2015, more than 800 campuses servicing approximately 4.9 million students purchased our Refund Management disbursement service. In total, there are more than 1,900 campuses servicing approximately 13 million students contracted to use at least one of our services. As of September 30, 2015, we also serviced approximately 2.0 million OneAccounts.

Our revenue fluctuates as a result of seasonal factors related to the academic year. A large portion of our revenue is either directly or indirectly dependent on academic financial aid received by students and in turn the number of students enrolled at our higher education institution clients. Higher education institutions typically disburse financial aid refunds to students at the start of each academic term. Distribution of financial aid disbursements through our Refund Management disbursement service (1) indirectly generates revenue through deposits of financial aid into OneAccounts, which generates account revenue, and (2) directly generates revenue through our higher education institution clients' use of the Refund Management disbursement service, which generates higher education institution revenue.

While revenue fluctuates over the course of our fiscal year, many of our expenses remain relatively constant, resulting in disparities in our net income and adjusted net income from quarter to quarter. Typically, the second quarter accounts for the smallest proportion of our revenues. This is primarily because the majority of financial aid is disbursed outside of this time period and higher education institutions tend to enroll more new students during the first and third fiscal quarters. We expect this trend to continue going forward.

Department of Education

In early 2014, the Department of Education, or ED, formed a negotiated rulemaking committee. Our Chief Operating Officer was selected by ED to serve on the committee as a primary negotiator. The committee convened in February, March, April and May of 2014 to discuss and work toward revising existing regulations to potentially address, among other things, consumer safeguards regarding debit and prepaid cards associated with Title IV Cash Management (including fees associated with such debit and prepaid cards), marketing of financial products (including sending unsolicited cards to students and co-branding of the card and materials) by institutions and their preferred banks or contractors, ATM access and availability, revenue sharing arrangements, and the potential for a government-sponsored debit or prepaid card solution. The negotiated rulemaking committee concluded its efforts in May 2014 and a consensus was not reached on any proposed regulations. Several of the views expressed at the sessions were unfavorable to certain of our current business practices.

On May 18, 2015, ED published its Notice of Proposed Rulemaking, or NPRM, on program integrity and improvement issues in the Federal Register. When ED published its NPRM the public comment period opened and remained opened until July 2, 2015 and we afforded ourselves of that opportunity to comment. Our comments focused on the provisions of the NPRM relating to cash management and campus debit cards including but not limited to the requirement of a 30-day across-the-board fee moratorium following each disbursement, imposed on top of other proposed fee restrictions, which could make providing accounts offered by third party servicers unviable and the confirmation of ED having the authorization to pay Title IV credit balances directly to students and parents which creates the risk of federalization of the disbursement process, thus discouraging private sector investment and innovation.

ED may publish these proposed rules in their current form or in a different form that may be more adverse to our business. Any rules substantially similar to those proposed could have a material adverse effect on our business. Should ED publish final rules in the Federal Register by November 2, 2015, we believe new Title IV Cash Management regulations would likely not go into effect until July 1, 2016.

Regulatory Matters

On May 9, 2014, the Federal Reserve Banks of Chicago (the responsible Reserve Bank for a former bank partner) and Philadelphia (the responsible Reserve Bank for a current bank partner) notified us that the Staff of the Board of Governors of the Federal Reserve System intended to recommend that the Board of Governors of the Federal Reserve System, or the Board of Governors, seek an administrative order against us with respect to asserted violations of the Federal Trade Commission Act. The cited violations relate to our activities with both a former and current bank partner and our marketing and disclosure practices related to the process by which students may select the OneAccount option for financial aid refund. On September 24, 2015, the Staff of the Board of Governors of the Federal Reserve System provided a revised notification to us with respect to those asserted violations of the Federal

Trade Commission Act. We are in discussions with the Staff of the Board of Governors and the Reserve Banks on this matter. The Staff of the Board of Governors has asserted that any administrative order may seek damages, including customer restitution and civil money penalties and changes to certain of our business practices.

In April 2015, the San Francisco Regional Office of the FDIC (the responsible Regional Office for a current bank partner) notified us it was prepared to recommend to the Director of the Division of Depositor and Consumer Protection that administrative enforcement action be taken against us for alleged violations of the Federal Trade Commission Act principally relating to our marketing and enrollment practices related to the OneAccount. We have responded to the FDIC's notification and we believe that these allegations are similar and related to the Federal Reserve Board allegations previously disclosed and discussed above. On September 24, 2015, the San Francisco Regional Office of the FDIC provided a revised notification to us regarding those alleged violations of the Federal Trade Commission Act.

During the year ended December 31, 2014, we recorded a liability of $8.75 million related to these matters. The liability, which continued to be recorded at $8.75 million through June 30, 2015, reflected the minimum amount we expected to pay related to these matters. During the three months ended September 30, 2015, we recorded an additional charge of $21.9 million related to these matters, bringing the total liability to $30.6 million, as a result of an updated assessment of the minimum amount we expect to pay related to these matters. Each of these amounts is shown as an allowance for customer restitution on our condensed consolidated statement of operations in the period in which the charge was incurred and is related to our disbursements segment. The total liability of $30.6 million is recorded within accrued expenses on our condensed consolidated balance sheets. While we believe that it is probable that we will have a loss related to these regulatory matters, in view of the inherent difficulty of predicting the outcomes of regulatory matters, we cannot predict the eventual outcomes of these pending matters, the timing of the ultimate resolution of these matters or an exact amount of loss associated with these matters. The liability recorded at September 30, 2015, reflects the minimum amount we expect to pay related to these matters, although there is a reasonable possibility that the liability will increase in future periods. The ultimate amount of restitution or civil money penalties is subject to many uncertainties and therefore impossible to predict, however we believe our exposure related to these matters is approximately $70.0 million in total. As disclosed in "Note 5 – Credit Facility" of our condensed consolidated financial statements, we amended our Credit Facility in February 2015. The amendment allows, among other things, for the payment of up to $75.0 million in connection with the resolution of the regulatory matters described above.

We believe that our cash flows from operations, together with our existing liquidity sources, will be sufficient to fund our operations and anticipated capital expenditures over the next twelve months. However, we may be required to pay material customer restitution and civil money penalties related to certain regulatory proceedings as described above. While the ultimate amounts of customer restitution or civil money penalties are subject to many uncertainties and therefore are impossible to predict, we believe that our cash flows from operations and liquidity sources available through our Credit Facility, as amended, will allow us to pay such customer restitution and civil money penalties.

Operating Segments and Reporting Units

As a result of changes in our operating segments and reporting units in 2015, we now have three operating segments, which are also reporting units. We compared the fair value of our reporting units to the carrying value of our reporting units at the time of the change in our operating segments and determined that there was no impairment of goodwill. However, the excess of fair value over carrying value does vary by reporting unit and the goodwill related to our Disbursements reporting unit could be susceptible to impairment in the future, particularly depending on the conclusion of those matters described above in "Overview – Department of Education" and "Overview – Regulatory Matters." An adverse conclusion to either or both of those matters could reduce the fair value of our reporting unit below the carrying value of the reporting unit and lead to an impairment charge in a future period. Also refer to "Critical Accounting Policies – Goodwill and Intangible Assets" below for additional information related to certain circumstances that could lead to an impairment of goodwill for the Disbursements reporting unit.

Agreement to Sell Campus Labs Assets

On October 14, 2015, we entered into an Asset Purchase Agreement with CL NewCo, Inc., or NewCo, an affiliate of Leeds Equity Partners, for the sale of substantially all of the assets of our data analytics business, or Campus Labs.

Pursuant to the terms of the Asset Purchase Agreement, NewCo agreed to acquire Campus Labs for a total cash purchase price of approximately $91 million. This purchase price is subject to certain closing adjustments including adjustments for working capital. The working capital adjustments will be determined at the time of closing, but may reduce the purchase price by $5 million to $7 million. The transaction is subject to necessary regulatory approvals and is expected to close by the end of November 2015.

We expect to receive proceeds, net of expenses and taxes, of between $55 million and $60 million from the transaction. As a condition of an amendment to our Credit Facility to allow for the sale of the Campus Labs assets, we will be required to repay $30 million of the outstanding amount on the Credit Facility when the sale of Campus Labs is complete. Refer to "Note 5 - Credit Facility" for additional information on the terms of the October amendment to our Credit Facility.

Results of Operations for the Three Months Ended September 30, 2015 and 2014

The following tables summarize key components of our results of operations for the periods indicated, both in dollars and as a percentage of total revenue:

	Three Months Ended September 30, (unaudited)				2015% of Gross Revenue	2014% of Gross Revenue
	2015	2014	$ Change	% Change		
	(in thousands)					
Revenue:						
Account revenue	$26,654	$31,468	$(4,814)	(15.3%)	47.3%	52.6%
Payment transaction revenue	19,055	18,197	858	4.7%	33.8%	30.4%
Higher education institution revenue	10,486	9,929	557	5.6%	18.6%	16.6%
Other revenue	167	181	(14)	(7.7%)	0.3%	0.3%
Gross revenue	56,362	59,775	(3,413)	(5.7%)	100.0%	100.0%
Less: allowance for customer restitution	(21,880)	-	(21,880)	100.0%	(38.8%)	-
Revenue	34,482	59,775	(25,293)	(42.3%)	61.2%	100.0%
Cost of revenue	27,817	28,182	(365)	(1.3%)	49.4%	47.1%
Gross profit	6,665	31,593	(24,928)	(78.9%)	11.8%	52.9%
Operating expenses:						
General and administrative	18,098	16,617	1,481	8.9%	32.1%	27.8%
Product development	2,040	1,555	485	31.2%	3.6%	2.6%
Sales and marketing	4,196	4,577	(381)	(8.3%)	7.4%	7.7%
Restructuring charge	334	-	334	100.0%	0.6%	-
Total operating expenses	24,668	22,749	1,919	8.4%	43.8%	38.1%
Income (loss) from operations	(18,003)	8,844	(26,847)	(303.6%)	(31.9%)	14.8%
Interest income	23	20	3	15.0%	0.0%	-
Interest expense	(1,262)	(828)	(434)	52.4%	(2.2%)	(1.4%)
Other income	77	(198)	275	(138.9%)	0.1%	(0.3%)
Net income (loss) before income taxes	(19,165)	7,838	(27,003)	(344.5%)	(34.0%)	13.1%
Income tax expense (benefit)	(6,510)	2,922	(9,432)	(322.8%)	(11.6%)	4.9%
Net income (loss)	$(12,655)	$4,916	$(17,571)	(357.4%)	(22.5%)	8.2%

The following table summarizes our gross revenue by our different lines of business:

	Three Months Ended September 30, (unaudited)					
	2015	2014	$ Change	% Change	2015% of Gross Revenue	2014% of Gross Revenue
	(in thousands)					
Disbursements	$28,194	$33,202	$(5,008)	(15.1%)	50.0%	55.5%
Payments	23,789	22,889	900	3.9%	42.2%	38.3%
Data Analytics	4,379	3,684	695	18.9%	7.8%	6.2%
Gross Revenue	$56,362	$59,775	$(3,413)	(-5.7%)	100.0%	100.0%

Revenue

Disbursements Revenue

The decrease in disbursements gross revenue during the three months ended September 30, 2015 was primarily due to a decrease in account revenue. The decrease in account revenue is a result of fewer OneAccounts and also fewer dollars spent by OneAccounts compared to the prior year, both of which had the effect of reducing interchange revenue and service fee revenue. There was an approximate 17% decrease in the total dollars deposited into OneAccounts compared to the same period in the prior year, which led to a similar decrease in amounts spent from OneAccounts. The amounts deposited and spent from OneAccounts typically move by similar amounts, but may vary by several percentage points from one reporting period to the next depending on specific deposit and spending behavior. The decrease in dollars deposited into OneAccounts was the result of fewer financial aid refunds being deposited to OneAccounts and fewer OneAccounts, partially offset by an increase in the amount of non-financial aid deposits made into OneAccounts. We experienced an approximate 5% increase in amounts deposited to OneAccounts from non-financial aid refund sources. Deposits from non-financial aid refund sources constituted approximately 14% of all deposits made to OneAccounts during the three months ended September 30, 2015, an increase from 11% during the comparable prior year period.

The higher education institution revenue earned from our Refund Management services was $1.4 million during the three months ended September 30, 2015, compared to $1.6 million during the three months ended September 30 2014.

As further described in "Note 6 – Commitments and Contingencies" to our condensed consolidated financial statements and the "Regulatory Matters" section within "*Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview,*" we recorded a liability of $21.9 million during the three months ended September 30, 2015, related to the potential requirement to provide restitution to certain OneAccount customers, which has been recorded as a reduction of our revenue.

Payments Revenue

The increase in payments revenue was due to higher payment transaction revenue, primarily due to an increase in the dollar volume of transactions processed through the SmartPay payment module during the three months ended September 30, 2015. The increase in payment transaction volume was primarily due to increases in volume at higher education institution clients that were processing payments during each of the three months ended September 30, 2015 and 2014. A portion of the higher revenue from the SmartPay payment module was offset by lower revenue associated with our tuition payment plan services.

Higher education institution revenue in the payments line of business was $4.7 million during each of the three months ended September 30, 2015 and 2014.

Data Analytics Revenue

The increase in data analytics revenue was due primarily to sales of Campus Labs modules to new higher education institution clients over the past twelve months.

Cost of Revenue

During the three months ended September 30, 2015, our gross margin percentage decreased, largely as a result of the allowance for customer restitution recorded in the three months ended September 30, 2015, described above. Excluding the impact of the allowance for customer restitution, our non-GAAP gross margin percentage would have been 50.6% during the three months ended September 30, 2015, compared to 52.9% in the three months ended September 30, 2014. The decrease in our non-GAAP gross margin percentage was primarily due to lower gross margin percentage in the disbursements line of business, including the OneAccount.

While gross revenue associated with our disbursements line of business decreased $5.0 million as described above, our cost of revenue to support that line of business decreased by $0.9 million to $15.2 million during the three months ended September 30, 2015, from $16.1 million in the comparable prior year period. The gross margin percentage for the disbursements line of business, excluding the impact of the allowance for customer restitution, was 46.1% during the three months ended September 30, 2015, compared to 51.6% in the comparable prior year period. The decrease in transaction volumes in OneAccounts led to a decrease in certain costs of revenue; however, those decreases were partially offset in other areas, primarily higher customer service related costs.

Our cost of revenue to support the payments line of business increased to approximately $12.1 million during the three months ended September 30, 2015, from $11.7 million in the comparable prior year period. The gross margin percentage for the payments line of business was 49.1% during the three months ended September 30, 2015, compared to 48.8% in the comparable prior year period. The increase in costs was primarily related to the growth of SmartPay transaction volume described above in “Revenue – *Payments Revenue.*”

Our cost of revenue to support the data analytics line of business increased to $0.5 million during the three months ended September 30, 2015, compared to $0.4 million during the three months ended September 30, 2014. The majority of the data analytics cost of revenue are related to amortization of acquisition-related intangible assets.

General and Administrative Expense

The increase in general and administrative expenses was primarily attributable to the following two factors: (i) increases in depreciation and amortization totaling approximately $0.7 million, including amortization related to internal use software, and (ii) our total personnel costs increased by approximately $0.3 million, including a $0.2 million increase in stock-based compensation expenses.

Product Development Expense

The increase in product development expense was primarily due to higher personnel costs, most of which related to product development for the data analytics line of business.

Sales and Marketing Expense

The decrease in sales and marketing expense was due primarily to amortization expense of approximately $0.3 million recorded during the three months ended September 30, 2014, which related to a marketing software platform which was no longer being utilized at that time.

Restructuring Charge

In April 2015, we entered into an agreement with a third-party service provider to operate our customer care center in order to provide live-agent, chat and interactive voice response services for our disbursements line of business, including the OneAccount. In connection with this agreement, we plan to reduce our employee workforce across our customer care department. We began the transition to the third-party service provider in July 2015 and expect to substantially complete the employee reduction by November 2015. However, the timing of this transition and of certain employee reductions may vary. We estimate we will recognize costs of up to $1.0 million during fiscal year 2015, consisting of severance and other employee-related benefits. Such costs are expected to be substantially accrued and paid through the end of the first quarter of 2016. For the three months ended September 30, 2015 we recognized restructuring charges of $0.3 million related to the plan described above. We expect to realize cost savings of approximately $4.0 million in 2016 through this arrangement.

Interest Expense

Our interest expense increased compared to the prior period due primarily to additional amortization of deferred financing costs. As a result of the February 2015 amendment to our credit facility, the interest expense associated with our deferred financing costs increased by $0.4 million to $0.5 million during the three months ended September 30, 2015. The average interest rate during the three months ended September 30, 2015 was 4.2%, an increase from 2.4% for the three months ended September 30, 2014. These increases were partially offset by lower amounts outstanding on our Credit Facility; the average amount outstanding on our Credit Facility was $59.0 million during the three months ended September 30, 2015, compared to an average of $94.0 million during the three months ended September 30, 2014.

Other Income (Loss)

Our other income (loss) during the three months ended September 30, 2014 included a loss of $0.3 million related to the disposition of our interest in FC Winchester Lofts Master Tenant, LLC.

Income Tax Expense

We recorded an income tax benefit during the three months ended September 30, 2015 as a result of our net loss before income taxes. The change in income tax expense (benefit) was primarily due to the decrease in net income before taxes. The effective tax rates for the three months ended September 30, 2015 and 2014 were 34.0% and 37.3%, respectively. Our effective tax rate is expected to be between 28% and 32% for the 2015 fiscal year. The decrease in our expected effective tax rate from the rate disclosed in our most recent Form 10-Q and the decrease in rate compared to the prior year period are due primarily to the allowance for customer restitution described above, which results in a pretax loss, the tax benefit on which is diminished by permanent differences between book and tax income.

Results of Operations for the Nine Months Ended September 30, 2015 and 2014

The following tables summarize key components of our results of operations for the periods indicated, both in dollars and as a percentage of total revenue:

	Nine Months Ended September 30, (unaudited)					
	2015	2014	$ Change	% Change	2015% of Gross Revenue	2014% of Gross Revenue
	(in thousands)					
Revenue:						
Account revenue	$88,523	$99,475	$(10,952)	(11.0%)	52.9%	57.9%
Payment transaction revenue	47,497	42,652	4,845	11.4%	28.4%	24.8%
Higher education institution revenue	30,891	28,958	1,933	6.7%	18.4%	16.9%
Other revenue	558	723	(165)	(22.8%)	0.3%	0.4%
Gross revenue	167,469	171,808	(4,339)	(2.5%)	100.0%	100.0%
Less: allowance for customer restitution	(21,880)	(8,750)	(13,130)	150.1%	(13.1%)	(5.1%)
Revenue	145,589	163,058	(17,469)	(10.7%)	86.9%	94.9%
Cost of revenue	77,479	76,878	601	0.8%	46.3%	44.7%
Gross profit	68,110	86,180	(18,070)	(21.0%)	40.7%	50.2%
Operating expenses:						
General and administrative	54,417	48,343	6,074	12.6%	32.5%	28.1%
Product development	6,120	5,517	603	10.9%	3.7%	3.2%
Sales and marketing	12,638	13,756	(1,118)	(8.1%)	7.5%	8.0%
Restructuring charge	574	-	574	100.0%	0.3%	-
Total operating expenses	73,749	67,616	6,133	9.1%	44.0%	39.4%
Income (loss) from operations	(5,639)	18,564	(24,203)	(130.4%)	(3.4%)	10.8%
Interest income	63	73	(10)	(13.7%)	0.0%	0.0%
Interest expense	(3,894)	(2,443)	(1,451)	59.4%	(2.3%)	(1.4%)
Other income	1,357	1,561	(204)	(13.1%)	0.8%	0.9%
Net income (loss) before income taxes	(8,113)	17,755	(25,868)	(145.7%)	(4.8%)	10.3%
Income tax expense (benefit)	(2,321)	6,900	(9,221)	(133.6%)	(1.4%)	4.0%
Net income (loss)	$(5,792)	$10,855	$(16,647)	(153.4%)	(3.5%)	6.3%

The following table summarizes our gross revenue by our different lines of business:

Nine Months Ended September 30,
(unaudited)

	2015	2014	$ Change	% Change	2015% of Gross Revenue	2014% of Gross Revenue
	(in thousands)					
Disbursements	$92,930	$103,833	$(10,903)	(10.5 %)	55.5 %	60.4 %
Payments	61,921	57,455	4,466	7.8 %	37.0 %	33.4 %
Data Analytics	12,618	10,520	2,098	19.9 %	7.5 %	6.1 %
Gross Revenue	$167,469	$171,808	$(4,339)	(-2.5 %)	100.0 %	100.0 %

Revenue

Disbursements Revenue

The decrease in disbursements revenue during the nine months ended September 30, 2015 was primarily due to a decrease in account revenue. The decrease in account revenue is a result of fewer OneAccounts and fewer dollars spent by OneAccounts, which had the effect of reducing both interchange revenue and service fee revenue when compared to the same period in the prior year. There was an approximate 11% decrease in total dollars deposited into OneAccounts compared to the same period in the prior year, which led to a similar decrease in amounts spent from OneAccounts. The amounts deposited and spent from OneAccounts typically move by similar amounts, but may vary by several percentage points from one reporting period to the next depending on specific deposit and spending behavior. The decrease in dollars deposited into OneAccounts was the result of fewer financial aid refunds being deposited to OneAccounts and fewer OneAccounts, partially offset by an increase in the amount of non-financial aid deposits made into OneAccounts. We experienced an approximate 7% increase in amounts deposited to OneAccounts from non-financial aid refund sources. Deposits from non-financial aid refund sources constituted approximately 17% of all deposits made to OneAccounts during the nine months ended September 30, 2015, an increase from 14% during the comparable prior year period.

The higher education institution revenue earned from our Refund Management services was $4.0 million during the nine months ended September 30, 2015, compared to $3.9 million during the nine months ended September 30 2014.

As further described in "Note 6 – Commitments and Contingencies" to our condensed consolidated financial statements and the "Regulatory Matters" section within "*Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview,*" we recorded a liability of $21.9 million and $8.75 million during the nine months ended September 30, 2015 and 2014, respectively, related to the potential requirement to provide restitution to certain OneAccount customers.

Payments Revenue

The increase in payments revenue was due to higher payment transaction revenue, primarily due to an increase in the dollar volume of transactions processed through the SmartPay payment module during the nine months ended September 30, 2015. The increase in payment transaction volume was primarily due to increases in volume at higher education institution clients that were processing payments during each of the nine months ended September 30, 2015 and 2014.

Higher education institution revenue in the payments line of business was $14.4 million during each of the nine months ended September 30, 2015 and 2014. We ceased providing disbursement services to those clients on the Campus Solutions refund disbursement platform in the fourth quarter of 2014 and therefore earned no revenue related to these services during the nine months ended September 30, 2015, compared to approximately $0.6 million during the nine months ended September 30, 2014. Offsetting that decrease is revenue associated with new services provided to higher education institution clients over the last twelve months.

Data Analytics Revenue

The increase in data analytics revenue was due primarily to sales of Campus Labs modules to new and previously existing higher education institution clients over the past twelve months.

Cost of Revenue

During the nine months ended September 30, 2015, our gross margin percentage decreased, largely as a result of the allowance for customer restitution recorded in the nine months ended September 30, 2015, described above. Excluding the impact of the allowance for customer restitution, our non-GAAP gross margin percentage would have been 53.7% during the nine months ended September 30, 2015, compared to 55.3% in the nine months ended September 30, 2014. The decrease in our non-GAAP gross margin percentage was primarily due to a decrease in gross margin percentage in the disbursements line of business, including the OneAccount.

While gross revenue associated with our disbursements line of business decreased $10.9 million as described above, our cost of revenue to support that line of business decreased only $0.8 million during the nine months ended September 30, 2015. The gross margin percentage for the disbursements line of business, excluding the impact of the allowance for customer restitution, was 51.3% during the nine months ended September 30, 2015, compared to 55.6% in the comparable prior year period. While the decrease in transaction volumes in OneAccounts led to a decrease in certain costs of revenue, those decreases were partially offset in other areas, primarily higher customer service related costs.

Our cost of revenue to support the payments line of business increased to approximately $30.7 million during the nine months ended September 30, 2015, from $29.5 million in the comparable prior year period. The gross margin percentage for the payments line of business was 50.3% during the nine months ended September 30, 2015, compared to 48.6% in the comparable prior year period. The increase in costs was primarily related to the growth of SmartPay transaction volume described above in "Revenue – *Payments Revenue*." This increase in costs was partially offset by a decrease in costs associated with supporting the Campus Solutions refund disbursement platform, which were $1.2 million during the nine months ended September 30, 2014.

Our cost of revenue to support the data analytics line of business increased to $1.4 million during the nine months ended September 30, 2015, compared to $1.2 million during the nine months ended September 30, 2014. The majority of the data analytics costs are related to amortization of acquisition-related intangible assets.

General and Administrative Expense

The increase in general and administrative expenses was primarily attributable to the following two factors: (i) our total personnel costs increased by approximately $2.7 million, including a $1.2 million increase in stock-based compensation expenses, and (ii) increases in depreciation and amortization totaling approximately $2.5 million, including amortization related to internal use software.

Product Development Expense

The increase in product development expense was primarily due to an increase of amortization expense of approximately $0.5 million related to the acceleration of amortization of a software platform no longer being utilized. In addition, higher personnel costs were offset by a decrease in transition-related product development expenses associated with the Campus Solutions acquisition which we incurred only in the prior year period.

Sales and Marketing Expense

The decrease in sales and marketing expense was due primarily to decreases in tradeshow costs and external advertising and marketing costs, including a decrease in costs related to branding efforts that took place during the nine months ended September 30, 2014.

Restructuring Charge

In April 2015, we entered into an agreement with a third-party service provider to operate our customer care center in order to provide live-agent, chat and interactive voice response services for our disbursements line of business, including the OneAccount product. In connection with this agreement, we plan to reduce our employee workforce across our customer care department. We began the transition to the third-party service provider in July 2015 and expect to substantially complete the employee reduction by November 2015. However, the timing of this transition and of certain employee reductions may vary. We estimate we will recognize costs of up to $1.0 million during fiscal year 2015, consisting of severance and other employee-related benefits. Such costs are expected to be substantially accrued and paid through the end of the first quarter of 2016. For the nine months ended September 30, 2015, we recognized restructuring charges of $0.6 million related to the plan described above. We expect to realize cost savings of approximately $4.0 million in 2016 through this arrangement.

Interest Expense

Our interest expense increased compared to the prior period due primarily to additional amortization of deferred financing costs. As a result of the February 2015 amendment to our credit facility, the interest expense associated with our deferred financing costs increased by $1.3 million to $1.7 million during the nine months ended September 30, 2015. The average interest rate during the nine months ended September 30, 2015 was 3.8%, an increase from 2.4% for the nine months ended September 30, 2014. These increases were partially offset by lower amounts outstanding on our Credit Facility; the average amount outstanding on our Credit Facility was $64.4 million during the nine months ended September 30, 2015, compared to an average of $94.5 million during the nine months ended September 30, 2014.

Other Income

Our other income during the nine months ended September 30, 2015 includes a payment of $1.1 million related to a settlement and licensing agreement with TouchNet, and its successor company Heartland Payment Systems, which resolved our complaints against TouchNet and their counterclaim against us. During the nine months ended September 30, 2014, we recorded other income of $1.6 million as a result of an agreement related to the resolution of certain escrow balances that were part of the acquisition of the Campus Solutions business. We also recorded other loss of $0.3 million during the nine months ended September 30, 2014 as a result of the disposition of our interest in FC Winchester Lofts Master Tenant, LLC.

Income Tax Expense

The change in income tax expense (benefit) was primarily due to the decrease in net income before taxes. The effective tax rates for the nine months ended September 30, 2015 and 2014, were 28.6% and 38.9%, respectively. Our effective tax rate is expected to be between 28% and 32% for the 2015 fiscal year. The decrease in our expected effective tax rate from the rate disclosed in our most recent Form 10-Q and the decrease in rate compared to the prior year period are due primarily to the result of the allowance for customer restitution described above, which results in a pretax loss, the tax benefit on which is diminished by permanent differences between book and tax income.

Liquidity and Capital Resources

Sources of Liquidity

Our primary sources of liquidity are cash flows from operations and borrowings under our Credit Facility, as defined below. As of September 30, 2015, we had $27.8 million in cash and cash equivalents, $0.3 million in available-for-sale investments and approximately $81.0 million in borrowing capacity available under our Credit Facility, $35.0 million of which is restricted as described below. Our primary liquidity requirements are for working capital, capital expenditures, product development expenses and general corporate needs. As of September 30, 2015, we had a working capital deficit of $18.4 million.

Senior Secured Revolving Credit Facility

In October 2012, we entered into a five-year senior secured revolving credit facility, or the Credit Facility. We amended the Credit Facility in February, June and October 2015, which modified certain of the financial covenants and other terms of the agreement, including the amount available for borrowing, as described in “Note 5 – Credit Facility” of our notes to consolidated financial statements. In connection with the February 2015 amendment, we paid down the outstanding balance of the Credit Facility by $35 million, expensed approximately $0.4 million of previously deferred financing costs and incurred new financing costs of approximately $4.5 million in February 2015, which are included in deferred costs as of September 30, 2015 in the accompanying condensed consolidated balance sheet. The Credit Facility permits the issuance of letters of credit of up to $20.0 million and swing line loans of up to $10.0 million to fund working capital needs. Loans drawn under the Credit Facility are payable in a single maturity on October 16, 2017. As of September 30, 2015, we had $59.0 million in borrowings outstanding, at a weighted average interest rate of 4.2%, under the Credit Facility. In connection with the October 2015 amendment, we are required to pay down the outstanding balance of the Credit Facility by $30.0 million upon the sale of the Campus Labs business. We expect to record an expense of approximately $1.9 million during the three months ended December 31, 2015 to write-off deferred financing costs in connection with the October 2015 amendment.

Each of HOH, HOMI, Real Estate Inc. and Real Estate LLC, or together with HOI, the Loan Obligors, is a guarantor of HOI's obligations under the Credit Facility. Loans drawn under the Credit Facility are secured by a perfected first priority security interest in all of the capital stock of HOI and its domestic subsidiaries, and substantially all of each Loan Obligor's tangible and intangible assets, including intellectual property. We pay a commitment fee of 0.5% on the daily average undrawn portion of revolving commitments under the Credit Facility, which accrues and is payable quarterly in arrears.

The Credit Facility contains certain affirmative covenants including covenants to furnish the lenders with financial statements and other financial information and to provide the lenders notice of material events and information regarding collateral. The Credit Facility also contains certain negative covenants that, among other things, restrict our ability, subject to certain exceptions, to incur additional indebtedness, grant liens on our assets, undergo fundamental changes, make investments, sell assets, make restricted payments, change the nature of our business and engage in transactions with our affiliates. The maturity of the Credit Facility could be accelerated upon a change of control or if we experience a material adverse change in our operations, condition or prospects. In addition, the Credit Facility contains certain financial covenants in addition to the covenants described above, including a requirement to maintain a fixed charge coverage ratio of at least 1.25 to 1.00. We were in compliance with each of the applicable affirmative, negative and financial covenants of the Credit Facility as of September 30, 2015. As of September 30, 2015, our trailing twelve month consolidated EBITDA was $53.7 million. Our leverage ratio was 1.10 to 1.00 as of September 30, 2015.

Cash Flows

The following table presents information regarding our cash flows and cash and cash equivalents for the nine months ended September 30, 2015 and 2014:

	Nine Months Ended September 30,		
	2015	**2014**	**$ Change**
	(unaudited) (in thousands)		
Net cash provided by (used in):			
Operating activities	$32,935	$20,903	$12,032
Investing activities	(6,170)	43	(6,213)
Financing activities	(39,002)	5,231	(44,233)
Change in cash and cash equivalents	$(12,237)	$26,177	$(38,414)
Cash and cash equivalents, end of period	$27,785	$32,445	$(4,660)

The increase in net cash provided by operating activities was primarily the result of changes in working capital balances during the nine months ended September 30, 2015, compared to the prior year. The consumer class action litigation settlement of $15.0 million was paid in cash during the nine months ended September 30, 2014. This payment is a significant component of the overall change in working capital balances and increase in cash provided by operating activities compared to the prior year. Also, our income receivable balance has decreased from the prior year due to an acceleration in the settlement of the revenue proceeds associated with the Campus Solutions business compared to the prior year.

The change in cash provided by (used in) investing activities primarily relates to cash provided by investing activities during the nine months ended September 30, 2014, as a result of (1) $3.6 million related to the disposition of an equity method investment and (2) $3.5 million associated with state historic tax credits generated by the construction of our headquarters. In addition, our purchases of fixed assets and internal use software development costs decreased by a total of $0.9 million during the nine months ended September 30, 2015, compared to the prior year period.

The change in cash provided by (used in) financing activities primarily relates to the cash used to repay debt in connection with the February 2015 amendment to our credit facility described above which totaled $39.5 million. In the prior year, we had net borrowings of $5.0 million on our Credit Facility.

We believe that our cash flows from operations, together with our existing liquidity sources, will be sufficient to fund our operations and anticipated capital expenditures over the next twelve months. As described in "Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview" we may be required to pay material customer restitution and civil money penalties related to certain regulatory proceedings. Please refer to the "Regulatory Matters" section within "Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview" for the impact that such regulatory matters may have on our liquidity.

Non-GAAP Supplemental Financial and Operating Information

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2015	**2014**	**2015**	**2014**
	(unaudited) (in thousands)			
Adjusted EBITDA	$11,211	$14,959	$39,478	$44,820
Adjusted net income	$4,191	$6,969	$16,220	$21,674
Number of students enrolled at OneDisburse client higher education institutions at end of period	4,918	5,018	4,918	5,018
Number of OneAccounts at end of period	2,038	2,190	2,038	2,190

We define adjusted EBITDA as net income before interest, income taxes and depreciation and amortization, or EBITDA, further adjusted to remove the effects of stock-based compensation expense, the receipt of a settlement amount from Sallie Mae, Inc. related to our Campus Solutions acquisition, the allowance for customer restitution and a restructuring charge. Neither EBITDA nor adjusted EBITDA should be considered an alternative to net income, operating income 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 do. In addition, adjusted EBITDA may not be identical to the corresponding measure used in our various agreements, in particular our Credit Facility.

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

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2015	**2014**	**2015**	**2014**
	(unaudited)			
Net income (loss)	$(12,655)	$4,916	$(5,792)	$10,855
Interest income	(23)	(20)	(63)	(73)
Interest expense	1,262	828	3,894	2,443
Income tax expense	(6,510)	2,922	(2,321)	6,900
Depreciation and amortization	5,563	5,235	16,429	14,123
EBITDA	(12,363)	13,881	12,147	34,248
Restructuring charge	334	-	574	-
Stock-based compensation expense	1,360	1,078	4,877	3,426
Allowance for customer restitution	21,880	-	21,880	8,750
Campus Solutions settlement received	-	-	-	(1,604)
Adjusted EBITDA	$11,211	$14,959	$39,478	$44,820

The following table presents adjusted EBITDA for each of our three lines of business for each of the periods indicated:

	Three Months Ended September 30,			**Nine Months Ended September 30,**	
	2015		**2014**	**2015**	**2014**
	(unaudited)				
	(in thousands)				
Disbursements	$ 3,084		$7,142	$18,759	$28,317
600					
Total liabilities	53,216	57,567			
Commitments and contingencies (Note 7)					
Stockholders' equity					
Preferred Stock, $0.001 par value:					
Authorized 50,000 shares; No shares issued or outstanding	—	—			
Common Stock, $0.001 par value:					
Authorized 1,000,000 shares; Issued and outstanding					
92,677 and 79,983 shares at December 31, 2016 and 2015, respectively	93	80			

Additional paid-in-capital	872,114	786,636
Accumulated other comprehensive income (loss)	5	(7)
Accumulated deficit	(787,544)	(713,169)
Total stockholders' equity	84,668	73,540
Total liabilities and stockholders' equity	$ 137,884	$ 131,107

See accompanying notes to the consolidated financial statements.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Operations and Comprehensive Loss

	Years ended December 31,		
(in thousands, except per share amounts)	2016	2015	2014
Revenue:			
Product revenue	$ 64,609	$ 37,502	$ 35,299
Service and other revenue	13,971	10,896	8,511
Contractual revenue	12,134	44,384	16,784
Total revenue	90,714	92,782	60,594
Cost of Revenue:			
Cost of product revenue	34,512	30,704	29,626
Cost of service and other revenue	12,042	8,628	7,566
Total cost of revenue	46,554	39,332	37,192
Gross profit	44,160	53,450	23,402
Operating Expense:			
Research and development	67,617	60,440	48,230
Sales, general and administrative	47,787	45,187	38,026
Gain on lease amendments	—	(23,043)	—
Total operating expense	115,404	82,584	86,256
Operating loss	(71,244)	(29,134)	(62,854)
Interest expense	(3,234)	(2,926)	(2,828)
Other income (expense), net	103	364	(478)
Net loss	(74,375)	(31,696)	(66,160)
Other comprehensive loss:			
Unrealized gain (loss) on investments	12	(16)	(5)
Comprehensive loss	$ (74,363)	$ (31,712)	$ (66,165)
Net loss per share:			
Basic and diluted net loss per share	$ (0.83)	$ (0.42)	$ (0.94)
Shares used in computing basic and diluted net loss per share	89,148	75,614	70,475

See accompanying notes to the consolidated financial statements.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Stockholders’ Equity

(in thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity
Balance at December 31, 2013	66,275	$ 66	$ 684,413	$ 14	$ (615,313)	$ 69,180
Net loss	—	—	—	—	(66,160)	(66,160)
Other comprehensive loss	—	—	—	(5)	—	(5)
Issuance of common stock in conjunction with equity plans	1,901	2	3,966	—	—	3,968
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	5,751	6	38,017	—	—	38,023
Stock-based compensation expense	—	—	9,943	—	—	9,943
Balance at December 31, 2014	73,927	74	736,339	9	(681,473)	54,949
Net loss	—	—	—	—	(31,696)	(31,696)
Other comprehensive loss	—	—	—	(16)	—	(16)
Issuance of common stock in conjunction with equity plans	1,981	2	7,361	—	—	7,363
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	4,075	4	29,096	—	—	29,100
Stock-based compensation expense	—	—	13,840	—	—	13,840
Balance at December 31, 2015	79,983	80	786,636	(7)	(713,169)	73,540
Net loss	—	—	—	—	(74,375)	(74,375)
Other comprehensive loss	—	—	—	12	—	12
Issuance of common stock in conjunction with equity plans	2,004	2	7,727	—	—	7,729
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	6,526	7	58,193	—	—	58,200
Issuance of common stock from exercise of warrant	4,164	4	(4)	—	—	—
Stock-based compensation expense	—	—	19,562	—	—	19,562
Balance at December 31, 2016	92,677	$ 93	$ 872,114	$ 5	$ (787,544)	$ 84,668

See accompanying notes to the consolidated financial statements.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Cash Flows

(in thousands)	Years Ended December 31, 2016	2015	2014
Cash flows from operating activities			
Net loss	$ (74,375)	$ (31,696)	$ (66,160)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization	3,875	3,677	4,221
Amortization of debt discount and financing costs	1,158	957	793
Stock-based compensation	19,562	13,840	9,943
Non-cash portion of gain on lease amendments	—	(3,043)	—
Other items	(147)	(230)	507
Changes in assets and liabilities			
Accounts receivable	(6,176)	(1,738)	(660)
Inventory	(6,151)	(2,466)	(1,285)
Prepaid expenses and other assets	(202)	(17,889)	(224)
Accounts payable	3,402	(716)	3,891
Accrued expenses	1,053	5,732	3,536
Deferred service revenue	469	708	2,686
Deferred contractual revenue	(12,134)	(14,386)	(6,784)
Other liabilities	1,737	(639)	(1,932)
Net cash used in operating activities	(67,929)	(47,889)	(51,468)
Cash flows from investing activities			
Purchase of property and equipment	(8,207)	(3,009)	(1,609)
Proceeds from disposal of property and equipment	10	36	—
Long-term restricted cash	—	(4,500)	—
Purchase of investments	(95,848)	(84,579)	(126,413)
Sales of investments	23,285	8,317	—
Maturities of investments	65,896	92,341	147,586
Net cash provided by (used in) investing activities	(14,864)	8,606	19,564
Cash flows from financing activities			
Proceeds from issuance of common stock from equity plans	7,729	7,363	3,968
Proceeds from issuance of common stock from "at-the-market" offering, net of issuance costs	58,200	29,100	38,023
Net cash provided by financing activities	65,929	36,463	41,991
Net increase (decrease) in cash and cash equivalents	(16,864)	(2,820)	10,087
Cash and cash equivalents at beginning of period	33,629	36,449	26,362
Cash and cash equivalents at end of period	$ 16,765	$ 33,629	$ 36,449
Supplemental disclosure of cash flow information			
Interest paid	$ 1,799	$ 1,794	$ 1,794

Supplemental disclosure of non-cash investing and financing activities			
Inventory transferred to property and equipment	1,282	2,846	—

See accompanying notes to the consolidated financial statements.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Notes to Consolidated Financial Statements

NOTE 1. OVERVIEW

We design, develop and manufacture sequencing systems to help scientists resolve genetically complex problems. Based on our novel Single Molecule, Real-Time (SMRT®) Sequencing technology, our products enable: de novo genome assembly to finish genomes in order to more fully identify, annotate and decipher genomic structures; full-length transcript analysis to improve annotations in reference genomes, characterize alternatively spliced isoforms and find novel genes; targeted sequencing to more comprehensively characterize genetic variations; and DNA base modification identification to help characterize epigenetic regulation and DNA damage. Our technology combines very high consensus accuracy and long read lengths with the ability to detect real-time kinetic information.

In September 2015, we announced that we had launched a new nucleic acid sequencing platform, the PacBio Sequel™ System (the "Sequel System"), which will provide higher throughput, more scalability, a reduced footprint and lower sequencing project costs compared to the PacBio® RS II System, while maintaining the existing benefits of our SMRT Technology.

The names "Pacific Biosciences," "PacBio," "SMRT," "SMRTbell," "Sequel" and our logo are our trademarks.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Consolidation

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States, or U.S. GAAP, as set forth in the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC. The consolidated financial statements include the accounts of Pacific Biosciences and our wholly owned subsidiaries. All intercompany transactions and balances have been eliminated. Translation adjustments resulting from translating foreign subsidiaries' results of operations and assets and liabilities into U.S. dollars are immaterial for all periods presented.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes to the financial statements. Our estimates include, but are not limited to, the valuation of inventory, revenue valuation, the valuation of a financing derivative and long-term notes, the valuation and recognition of share-based compensation, the delivery period for collaboration agreements, the useful lives assigned to long-lived assets, and the computation provisions for income taxes. Actual results could differ materially from these estimates.

During 2013, we entered into a Development, Commercialization and License Agreement (the "Roche Agreement") with F. Hoffman-La Roche Ltd ("Roche") and received a non-refundable up-front payment of $35.0 million. Revenue for the year ended December 31, 2014 included four quarterly periods of amortization of $1.7 million from the non-refundable up-front payment of $35.0 million. During the first quarter of 2015, we revised the estimated period over which the delivery of elements pursuant to the Roche Agreement was expected to occur due to an increased level of certainty regarding the development period. As a result, we began, on a prospective basis, recognizing the remaining deferred contractual revenue associated with the upfront payment received under the Roche Agreement over the revised estimated remaining development period. For the year ended December 31, 2015, this change in estimate increased contractual revenue by $7.6 million, and decreased our basic and diluted net loss per share by $0.10. Quarterly amortization of $3.6 million was recognized as contractual revenue for each of the four quarters of 2015 and for each of the first three quarters of 2016. In December 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. Upon such notice in December 2016, no further participation on the joint steering committee was deemed necessary; as such, we recognized the entire then-remaining unamortized deferred revenue of $1.3 million as contractual revenue in the fourth quarter of 2016.

Fair Value of Financial Instruments

The carrying amount of our accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses and other liabilities, current, approximate fair value due to their short maturities. The carrying value of our other liabilities, non-current, approximates fair value due to the time to maturity and prevailing market rates.

The fair value hierarchy established under U.S. GAAP requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument’s categorization within the fair value hierarchy is based upon the lowest level input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are as follows:

- Level 1: quoted prices in active markets for identical assets or liabilities;

- Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

- Level 3: unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

We consider an active market as one in which transactions for the asset or liability occurs with sufficient frequency and volume to provide pricing information on an ongoing basis. Conversely, we view an inactive market as one in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers. Where appropriate, our non-performance risk, or that of our counterparty, is considered in determining the fair values of liabilities and assets, respectively.

We classify our cash deposits and money market funds within Level 1 of the fair value hierarchy because they are valued using bank balances or quoted market prices. We classify our investments as Level 2 instruments based on market pricing and other observable inputs. We did not classify any of our investments within Level 3 of the fair value hierarchy.

Assets and liabilities measured at fair value are classified in their entirety based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the entire fair value measurement requires management to make judgments and consider factors specific to the asset or liability.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table sets forth the fair value of our financial assets and liabilities that were measured on a recurring basis as of December 31, 2016 and 2015, respectively (in thousands):

	December 31, 2016				December 31, 2015			
(in thousands)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets								
Cash and cash equivalents:								
Cash and money market funds	$ 14,516	$ —	$ —	$ 14,516	$ 22,034	$ —	$ —	$ 22,034
Commercial paper	—	2,249	—	2,249	—	8,595	—	8,595
US government & agency securities	—	—	—	—	—	3,000	—	3,000
Total cash and cash equivalents	14,516	2,249	—	16,765	22,034	11,595	—	33,629
Investments:								
Commercial paper	—	23,583	—	23,583	—	15,903	—	15,903
Corporate debt securities	—	10,739	—	10,739	—	1,265	—	1,265
US government & agency securities	—	20,579	—	20,579	—	28,136	—	28,136

Asset backed securities	—	312	—	312	—	3,337	—	3,337
Total investments	—	55,213	—	55,213	—	48,641	—	48,641
Long-term restricted cash:								
Cash	4,500	—	—	4,500	4,500	—	—	4,500
Total assets measured at fair value	$ 19,016	$ 57,462	$ —	$ 76,478	$ 26,534	$ 60,236	$ —	$ 86,770
Liabilities								
Financing derivative	$ —	$ —	$ 356	$ 356	$ —	$ —	$ 600	$ 600
Total liabilities measured at fair value	$ —	$ —	$ 356	$ 356	$ —	$ —	$ 600	$ 600

The estimated fair value of the Financing Derivative liability (as defined in “Note 6. Notes Payable’) was determined using Level 3 inputs, or significant unobservable inputs. Refer to “Note 6. Notes Payable” for a detailed description and valuation approach. Changes to the estimated fair value of the Financing Derivative are recorded in “Other income (expense), net” in the consolidated statements of operations and comprehensive loss.

The following table provides the changes in the fair value of the Financial Derivative for the year ended December 31, 2016 and 2015 (in thousands), respectively:

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Financing Derivative	Amount
Balance as of December 31, 2014	$ 944
Gain on change in fair value of Financing Derivative	(344)
Balance as of December 31, 2015	600
Gain on change in fair value of Financing Derivative	(244)
Balance as of December 31, 2016	$ 356

For the year ended December 31, 2016, there were no transfers between Level 1, Level 2, or Level 3 assets or liabilities reported at fair value on a recurring basis and our valuation techniques did not change compared to the prior year.

Financial Assets and Liabilities Not Measured at Fair Value on a Recurring Basis

The carrying amount of our accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses and other current liabilities approximate fair value due to their short maturities. The carrying value of our facility financing obligation approximates fair value due to the time to maturity and prevailing market rates.

We determined the fair value of the Notes (as defined in “Note 6. Notes Payable”) from the debt facility we entered into during the first quarter of 2013 using Level 3 inputs, or significant unobservable inputs. The value of the Notes was determined by comparing the difference between the fair value of the Notes with and without the Financing Derivative by calculating the respective present values from future cash flows using a 10.6% and 13.5% weighted average market yield at December 31, 2016 and December 31, 2015, respectively. Refer to “Note 6. Notes Payable” for additional details regarding the Notes. The estimated fair value and carrying value of the Notes are as follows (in thousands):

	December 31, 2016		December 31, 2015	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Long-term notes payable	$ 19,788	$ 16,106	$ 18,037	$ 14,948

Cash and Cash Equivalents

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Investments

We have designated all investments as available-for-sale and therefore, such investments are reported at fair value, with unrealized gains and losses recognized in accumulated other comprehensive income (loss) ("OCI") in stockholders' equity. The cost of marketable securities is adjusted for the amortization of premiums and discounts to expected maturity. Premium and discount amortization is included in other income, net. Realized gains and losses, as well as interest income, on available-for-sale securities are also included in other income, net. The cost of securities sold is based on the specific identification method. We include all of our available-for-sale securities in current assets.

All of our investments are subject to a periodic impairment review. We recognize an impairment charge when a decline in the fair value of our investments below the cost basis is judged to be other-than-temporary. Factors considered in determining whether a loss is temporary include the length of time and extent to which the investments fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, extent of the loss related to credit of the issuer, the expected cash flows from the security, our intent to sell the security and whether or not we will be required to sell the security before the recovery of its amortized cost. During the years ended December 31, 2016, 2015 and 2014, we did not recognize any impairment charges on our investments as it is more likely than not that we will recover their amortized cost basis upon sale or maturity.

Concentration and Other Risks

The counterparties to the agreements relating to our investment securities consist of various major corporations, financial institutions, municipalities and government agencies of high credit standing. Our accounts receivable are derived from net revenue to customers and distributors located in the United States and other countries. We perform credit evaluations of our customers' financial condition and, generally, require no collateral from our customers. We regularly review our accounts receivable including consideration of factors such as historical experience, credit quality, the age of the accounts receivable balances and current economic conditions that may affect a customer's ability to pay. We have not experienced any significant credit losses to date.

For the years ended December 31, 2016, 2015 and 2014, excluding contractual revenue, no single end customer accounted for more than 10% of our total revenue.

As of December 31, 2016 and 2015, 84% and 64%, respectively, of our accounts receivable were from domestic customers. As of December 31, 2016, no single customer represented more than 10% of our net accounts receivable. As of December 31, 2015, four customers each represented more than 10% of our net accounts receivable.

We currently purchase several key parts and components used in the manufacture of our products from a limited number of suppliers. Generally we have been able to obtain an adequate supply of such parts and components. However, an extended interruption in the supply of parts and components currently obtained from our suppliers could adversely affect our business and consolidated financial statements.

Inventory

Inventory is valued at the lower of standard cost, which approximates actual cost, or market. Cost is determined using the first-in, first-out ("FIFO") method. Adjustments to reduce the cost of inventory to its net realizable value, if required, are made for estimated excess or obsolete balances.

Property and Equipment, Net

Property and equipment are stated at cost, net of accumulated depreciation and any impairment charges. Depreciation is computed using the straight-line method over the estimated useful life of the asset, generally two to three years for computer equipment, three to five years for software, three to seven years for furniture and fixtures, three years for lab equipment and 30 years for buildings. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life of the related asset. Major improvements are capitalized, while maintenance and repairs are expensed as incurred.

In connection with build-to-suit lease arrangements that we account for as if we own the facility, we record the facility at the fair value at the date construction commences, prior to significant renovations, plus the costs of the renovations. We determined the fair value of such facilities prior to renovation based on several factors, including an appraisal conducted by an independent licensed appraiser.

Long-term Restricted Cash

Long-term restricted cash as of December 31, 2016 was comprised of $4.5 million pledged as collateral for an irrevocable letter of credit for our O'Brien Lease entered into in July 2015. The letter of credit currently expires in more than one year. The time deposit securing the letter of credit was classified as Long-term restricted cash in the accompanying consolidated balance sheets as of December 31, 2016.

Impairment of Long-Lived Assets

We periodically review property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset is impaired or the estimated useful lives are no longer appropriate. Fair value is estimated based on discounted future cash flows. If indicators of impairment exist and the undiscounted projected cash flows associated with such assets are less than the carrying amount of the asset, an impairment loss is recorded to write the asset down to its estimated fair value. To date, we have not recorded any impairment charges.

Revenue Recognition

Our revenue is generated primarily from the sale of products and services, in addition to revenue from collaboration agreements. Product revenue consists of sales of our instruments and related consumables; Service and other revenue primarily consist of revenue earned from product maintenance agreements, instrument lease agreements and grant revenue. Contractual revenue relates to revenue recognized from the collaboration agreement under which we received an upfront fee and may receive contingent milestone payments. Our deliverables under the arrangement include licenses to intellectual property rights and research and development services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. For instances where final acceptance of the product or system is required, revenue is deferred until all acceptance criteria have been met. Revenue for product sales is generally recognized upon customer acceptance. For certain qualified distributors revenue is recognized based upon shipment terms. Revenue for product maintenance agreements is recognized when earned, which is generally ratably over the service period. In order to assess whether the price is fixed or determinable, we evaluate whether refund rights exist. If refund rights exist or payment terms are based on future performance, we defer revenue recognition until the price becomes fixed or determinable. We assess collectability based on a number of factors, including customer creditworthiness. If we determine that collection of amounts due is not reasonably assured, revenue recognition is deferred until receipt of payment.

We regularly enter into arrangements, comprised of one or more contracts, from which revenue is derived from multiple deliverables including a mix of products and or services. Revenue recognition for contracts with multiple deliverables is based on the individual units of accounting determined to exist in the contract. A delivered item is considered a separate unit of accounting when (i) the delivered item has value to the customer on a stand-alone basis; and (ii) if a general right of return exists, the delivery or performance of an undelivered item is considered probable and under our control. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. Our revenue arrangements generally do not have a general right of return. When a deliverable does not meet the criteria to be considered a separate unit of accounting, we group it with other deliverables that, when combined, meet the criteria, and the appropriate allocation of arrangement consideration and revenue recognition is determined. Consideration is allocated at the inception of the contract to all deliverables based on their relative selling price. In order to determine the relative selling price of a deliverable, we apply, in order, vendor-specific objective evidence ("VSOE"); third-party evidence if VSOE is not available; and lastly our best estimate of selling price for the deliverable if neither VSOE nor third-party evidence is available.

In order to establish VSOE, we must regularly sell the product or service on a standalone basis with a substantial majority of sales priced within a relatively narrow range. If an insufficient number of standalone sales exist and VSOE cannot be determined, we then consider whether third party evidence can be used to establish selling price. Due to the lack of similar products and services sold by other companies within our industry, we have not established selling price using third-party evidence. If neither VSOE nor third party evidence of selling price exists, we determine our best estimate of selling price using a combination of prices set by our pricing committee adjusted for applicable discounts and customer orders received to date.

For our collaboration agreement, the process for determining estimates of selling prices of the identifiable deliverables involves significant judgments and estimates to be made by management. Our process considers multiple factors such as estimated headcount, annual research and development budget, estimated length of the research and development period and estimated transfer price on cost, which may vary over time, depending upon the circumstances, and are specific to each deliverable.

Deferred service revenue primarily represents product maintenance agreement revenue that is expected to be recognized over the related service period, generally one to three years.

For instrument lease agreements we entered into with our customers so far, they are classified as operating-type leases and revenue from these leases is recognized on a straight-line basis over the respective lease term, once the lessee takes (or has the right to take) control/possession of the property under the lease. Effectively, this occurs once installation is complete and acceptance has been obtained.

We recognize milestone revenues as they become earned. Based on Accounting Standards Codification, or ASC, Topic 605-28, Revenue Recognition — Milestone Method, we evaluate contingent milestones at inception of the agreement, and recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is considered substantive in its entirety. Milestones are considered substantive if the consideration earned from the achievement of the milestone (i) is consistent with performance required to achieve the milestone or the increase in value to the delivered item, (ii) relates solely to past performance and (iii) is reasonable relative to all of the other deliverables and payments within the arrangement.

Cost of Revenue

Cost of revenue reflects the direct cost of product components, third-party manufacturing services and our internal manufacturing overhead and customer service infrastructure costs incurred to produce, deliver, maintain and support our instruments, consumables, and services. There are no incremental costs associated with our contractual revenue; all product development costs are reflected in research and development expense.

Manufacturing overhead is predominantly comprised of labor and facility costs. We determine and capitalize manufacturing overhead into inventory based on a standard cost model that approximates actual costs. Prior to achieving manufacturing volumes that correlated with our estimated normal capacity (the production levels expected to be achieved over a number of periods under normal circumstances with available resources), we based our capitalized overhead relative to our normal capacity. Prior to achieving normal capacity, excess manufacturing resources were engaged in research and development activities, including; next generation products, internal use research products, and general support activities. As such, manufacturing costs in excess of amounts reflected in inventory were expensed as a component of research and development expense.

Service costs include the direct costs of components used in support, repair and maintenance of customer instruments as well as the cost of personnel, materials, shipping and support infrastructure necessary to support the installed customer base.

Research and Development

Research and development expense consists primarily of expenses for personnel engaged in the development of our SMRT technology, the design and development of our future products and current product enhancements. These expenses also include prototype-related expenditures, development equipment and supplies, facilities costs and other related overhead. We expense research and development costs during the period in which the costs are incurred. However, we defer and capitalize non-refundable advance payments made for research and development activities until the related goods are received or the related services are rendered.

Leases

We categorize leases at their inception as either operating or capital leases. On certain of our lease agreements, we may receive tenant improvement allowances, rent holidays and other incentives. Rent expense is recorded on a straight-line basis over the term of the lease. The difference between rent expense recognized and amounts paid under the lease agreement is recorded as deferred rent in the balance sheets. Leasehold improvements are capitalized at cost and depreciated over the shorter of their expected useful life or the life of the lease. Tenant improvements afforded to us by landlord incentives are recorded as leasehold improvement assets with corresponding deferred rent liabilities.

For build-to-suit lease arrangements, we evaluate the extent of our financial and operational involvement in the tenant improvements to determine whether we are considered the owner of the construction project under U.S. GAAP. When we are considered the owner of a project, we record the shell of the facility at its fair value at the date construction commences with a corresponding facility financing obligation. Improvements to the facility during the construction project are capitalized and, to the extent funded by lessor afforded incentives, with corresponding increases to the facility financing obligation. Payments we make under leases in which we are considered the owner of the facility are allocated to land rental expense, based on the relative values of the land and building at the commencement of construction, reductions of the facility financing obligation and interest expense recognized on the outstanding obligation. To the extent gross future payments do not equal the recorded liability, the liability is settled upon return of the facility to the lessor. Any difference between the book value of the assets and remaining facility obligation are recorded in other expense, net. For existing arrangements, the differences are expected to be immaterial.

Income Taxes

We account for income taxes under the asset and liability method, which requires, among other things, that deferred income taxes be provided for temporary differences between the tax basis of our assets and liabilities and the amounts reported in the financial statements. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating losses and research and development credit carryforwards. A full valuation allowance is provided against our net deferred tax assets as it is more likely than not that the deferred tax assets will not be fully realized.

We review our positions taken relative to income taxes. To the extent our tax positions are more likely than not to result in the payout of additional taxes, we accrue the estimated amount of tax for such uncertain positions.

Stock-based Compensation

Stock-based compensation expense for all stock-based compensation awards is based on the grant date fair value estimated using the Black-Scholes option pricing model. We have limited historical information available to support the underlying estimates of certain assumptions required to value stock options. The expected term of options is estimated based on the simplified method. We do not have sufficient trading history to solely rely on the volatility of our own common stock for establishing expected volatility. Therefore, we based our expected volatility on the historical stock volatilities of our common stock as well as several comparable publicly listed companies over a period equal to the expected term of the options. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the stock option. We estimate our forfeiture rate based on an analysis of our actual forfeitures and will continue to evaluate the adequacy of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover behavior and other factors. The impact from a forfeiture rate adjustment will be recognized in full in the period of adjustment, and if the actual number of future forfeitures differs from that which was estimated, we may be required to record adjustments to stock-based compensation expense in future periods. We recognize compensation expense on a straight-line basis over the requisite service period. We elected to use the simplified method to calculate the beginning pool of excess tax benefits.

Other Comprehensive Income (loss)

Other comprehensive income (loss) is comprised of unrealized gains (losses) on our investment securities.

Recent Accounting Pronouncements

Recently Adopted Accounting Standards

In July 2015, the FASB issued Accounting Standards Update ("ASU") No. 2015-11, Simplifying the Measurement of Inventory, which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost and net realizable value test. ASU 2015-11 is effective for annual report periods beginning after December 15, 2016 and is effective for us in the first quarter of 2017. We have elected to early adopt ASU 2015-11 effective beginning with the three-month period ended March 31, 2016, as permitted by the standard. The early adoption of this update 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 Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern, which requires management to evaluate whether there are conditions or events that raise substantial doubt about an entity's ability to continue as a going concern and to provide disclosures when certain criteria are met. The guidance is effective for annual periods beginning after December 15, 2016 and interim reporting periods starting in the first quarter of 2017. We adopted this standard as of December 31, 2016.

Recently Issued Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which amends the current stock compensation guidance. The amendments simplify the accounting for the taxes related to stock based compensation, including adjustments to how excess tax benefits and a company's payments for tax withholdings should be classified. Furthermore, the amendments allow the entities to make an accounting policy election to either estimate forfeitures or recognize forfeitures as they occur. If an election is made, the change to recognize forfeitures as they occur must be adopted using a modified retrospective approach with a cumulative effect adjustment recorded to opening retained earnings. The standard is effective for fiscal periods beginning after December 15, 2016, with early adoption permitted. We are currently evaluating which forfeiture method to use. In either scenario it will not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases. The guidance in ASU 2016-02 supersedes the lease recognition requirements in ASC Topic 840, Leases. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease for both financing and operating leases, along with additional qualitative and quantitative disclosures. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or the cumulative effect transition method. ASU 2014-09 is effective for periods beginning after December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of 2018. We are currently evaluating the new guidance to determine the impact it may have on our consolidated financial statements.

While we are continuing to assess all potential impacts of the new accounting standard, we currently believe the most significant impact relates to our accounting for incremental cost of obtaining a contract with a customer (i.e. sales commission). Under current GAAP, the cost incurred to obtain a contract is recognized in the period the expense is incurred while under the new standard, the incremental costs to obtain the contract will be allocated to the performance obligations using the relative fair value of these obligations, recognized as an asset and amortized over the useful life of that asset. We are still in the process of evaluating the impact of this new standard on these arrangements. Due to the complexity of certain of our contracts, the actual revenue recognition treatment required under the new standard for these arrangements may be dependent on contract-specific terms and vary in some instances.

NOTE 3. CONTRACTUAL REVENUE

In September 2013, we entered into the “Roche Agreement” with Roche, pursuant to which we accounted for, and recognized as revenue, the up-front payment received thereunder using the proportional performance method over the periods in which the delivery of elements pursuant to the Roche Agreement occurs. We recognized revenue under the Roche Agreement using a straight-line convention over the service periods of the deliverables as this method approximated our performance of services pursuant to the Roche Agreement. Out of the $35.0 million upfront cash payment received, quarterly amortization of $1.7 million was recognized as contractual revenue from the fourth quarter of 2013 to the fourth quarter of 2014. Beginning in the three-month period ended March 31, 2015, we revised the estimated development period related to our contractual revenue amortization based on increasing certainty of the development time on a prospective approach and quarterly amortization of $3.6 million was recognized as contractual revenue for each of the four quarters of 2015 and for each of the first three quarters of 2016. As of September 30, 2016, the total deferred contractual revenue balance was $1.3 million, relating to the amount allocated to the deliverable of our participation on the joint steering committee. In December 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. Upon such notice in December 2016, no further participation on the joint steering committee was deemed necessary; as such, we recognized the entire remaining unamortized deferred revenue of $1.3 million as contractual revenue in the fourth quarter of 2016. As a result of Roche’s termination of the Roche Agreement, it may be more difficult for us to successfully market, sell and commercialize our products into the markets that Roche would have addressed under the Roche Agreement.

Further, the Roche Agreement provided for additional payments totaling $40.0 million upon the achievement of certain development milestones, all of which have previously been received and recognized as revenue. Consideration from development milestones is recognized in the period in which a milestone is achieved only if the milestone is considered substantive in its entirety. We achieved the first development milestone under the Roche Agreement and recognized the related $10.0 million as contractual revenue during the year ended December 31, 2014. We achieved the second and the third (final) development milestones under the Roche Agreement and recognized the related $10.0 million and $20.0 million as contractual revenue during the three-month periods ended June 30, 2015 and December 31, 2015, respectively. There are no other milestones remaining to be achieved.

NOTE 4. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The following table summarizes our cash, cash equivalents and investments as of December 31, 2016 and December 31, 2015 (in thousands):

	As of December 31, 2016			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				
Cash and money market funds	$ 14,516	$ —	$ —	$ 14,516
Commercial paper	2,249	—	—	2,249
Total cash and cash equivalents	16,765	—	—	16,765
Investments:				
Commercial paper	23,581	5	(3)	23,583
Corporate debt securities	10,741	1	(3)	10,739
Asset backed securities	312	—	—	312
US government & agency securities	20,574	7	(2)	20,579
Total investments	55,208	13	(8)	55,213
Total cash, cash equivalents and investments	$ 71,973	$ 13	$ (8)	$ 71,978
Long-term restricted cash:				
Cash	$ 4,500	$ —	$ —	$ 4,500

	As of December 31, 2015			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				
Cash and money market funds	$ 22,034	$ —	$ —	$ 22,034
Commercial paper	8,595	—	—	8,595
US government & agency securities	3,000	—	—	3,000
Total cash and cash equivalents	33,629	—	—	33,629
Investments:				
Commercial paper	15,903	2	(2)	15,903
Corporate debt securities	1,266	—	(1)	1,265
Asset backed securities	3,337	—	—	3,337
US government & agency securities	28,142	4	(10)	28,136
Total investments	48,648	6	(13)	48,641
Total cash, cash equivalents and investments	$ 82,277	$ 6	$ (13)	$ 82,270
Long-term restricted cash:				
Cash	$ 4,500	$ —	$ —	$ 4,500

The following table summarizes the contractual maturities of our cash equivalents and available-for-sale investments, excluding money market funds, as of December 31, 2016:

(in thousands)	Fair Value
Due in one year or less	$ 57,462

Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without call or prepayment penalties.

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NOTE 5. BALANCE SHEET COMPONENTS

Inventory

As of December 31, 2016 and 2015, our inventory consisted of the following components:

	December 31,	
(in thousands)	2016	2015
Purchased materials	$ 4,817	$ 4,041
Work in process	7,287	3,576
Finished goods	3,530	3,338
Inventory	$ 15,634	$ 10,955

Prepaid Expenses and Other Current Assets

As of December 31, 2016 and 2015, our prepaid expenses and other current assets consisted of the following components:

	December 31,	
(in thousands)	2016	2015
Receivable from Existing Landlord	$ 5,000	$ 10,000
Rent deposits for O'Brien building	2,160	—
Prepaid expenses	2,342	1,330
Other current assets	476	741
Prepaid expenses and other current assets	$ 9,978	$ 12,071

Other Long-term Assets

As of December 31, 2016 and 2015, our other long-term assets consisted of the following components:

December 31,

(in thousands)	2016	2015
Receivable from Existing Landlord	$ —	$ 5,000
Rent deposits and tenant improvements for O'Brien building	9,641	2,160
Other	172	358
Other long-term assets	$ 9,813	$ 7,518

Receivable from existing landlord of $10.0 million as of December 31, 2015 was part of the $15.0 million of future payments receivable from our existing landlord for our Menlo Park facility real property leases, as described in further details in "Note 7. Commitments and Contingencies." Of the amount receivable, $10.0 million was recorded as a short-term receivable in "Prepaid and Other Current Assets" and the final $5.0 million was recorded in "Other Long-term Assets" as of December 31, 2015, based on the expected timing of receipt of the payment. During the year ended December 31, 2016, two $5.0 million Landlord Payments were received in February 2016 and in August 2016 and at December 31, 2016, the final $5.0 million was recorded in "Prepaid Expenses and Other Current Assets" in the consolidated balance sheets.

In addition, rent deposits and tenant improvements for our 1305 O'Brien building of $9.6 million and $2.2 million were recorded, respectively, in "Other long-term assets" in the consolidated balance sheets at December 31, 2016 and 2015.

In January 2017, we entered into a Third Lease Amendment Agreement with the Existing Landlord that increased the amount of the payments receivable from the Existing Landlord by $65,000.

Property and Equipment, Net

As of December 31, 2016 and 2015, our property and equipment, net, consisted of the following components:

(in thousands)	December 31, 2016	2015
Building	$ 1,160	$ 1,160
Laboratory equipment and machinery	23,337	20,358
Leasehold improvements	8,138	8,348
Computer equipment	7,170	6,781
Software	5,189	4,798
Furniture and fixtures	823	968
Construction in progress	5,772	—
	51,589	42,413
Less: Accumulated depreciation	(37,029)	(33,865)
Property and equipment, net	$ 14,560	$ 8,548

At December 31, 2016, out of the construction-in-progress balance of $5.8 million, approximately $5.2 million related to1305 O'Brien building purchases.

Depreciation expense during the years ended December 31, 2016, 2015 and 2014 was $3.9 million, $3.7 million and $4.2 million, respectively.

Accrued Expenses

As of December 31, 2016 and 2015, our accrued expenses consisted of the following components:

(in thousands)	December 31, 2016	2015
Salaries and benefits	$ 8,562	$ 8,129
Accrued license and development services	5,411	5,459
Inventory accrual, professional services, accrued interest and other	2,631	1,963
Accrued expenses	$ 16,604	$ 15,551

NOTE 6. NOTES PAYABLE

Facility Agreement

Pursuant to a Facility Agreement (the “Facility Agreement”) we entered into with entities affiliated with Deerfield Management Company, L.P. (collectively, “Deerfield”) during February 2013, we issued promissory notes in the aggregate principal amount of $20.5 million (the “Notes”). The Notes bear simple interest at a rate of 8.75% per annum, payable quarterly in arrears commencing on April 1, 2013.

In connection with the execution of the Facility Agreement, we issued warrants to purchase an aggregate of 5.5 million shares of common stock immediately exercisable at an exercise price per share initially equal to $2.63 (the “Warrants”). During the year ended December 31, 2016, warrants to purchase 5.5 million shares of common stock were net exercised, resulting in the issuance of approximately 4.2 million shares. The cashless net exercises of the warrants did not result in any additional funds being collected by us. As of December 31, 2016, no warrants remained outstanding.

In addition, the Facility Agreement requires us to maintain consolidated cash and cash equivalents on the last day of each calendar quarter of not less than $2.0 million. As security for our repayment of our obligations under the Facility Agreement, we granted to Deerfield a security interest in substantially all of our property.

The Facility Agreement has a maximum term of seven years from inception. Subsequent to the date of the Facility Agreement, at the election of the holders of Notes representing a majority of the aggregate principal amount of the outstanding Notes, the Notes holders may elect to receive 25% of the net proceeds from any financing that includes an equity component, including without limitation, the sale or issuance of our common stock, options, warrants or other securities convertible or exchangeable for shares of our common stock, as payment of the Notes. This right is subject to certain exceptions set forth in the Facility Agreement. The Notes holders have the option to require us to repay the Notes if we complete a Major Transaction (as defined in the Facility Agreement), including a change of control or a sale of all or substantially all of our assets. Additionally, the principal balance of the Facility Agreement may become immediately due and payable upon an Event of Default (as defined in the Facility Agreement), in which case the Notes holders would have the right to require us to repay 100% of the principal amount of the loan, plus any accrued and unpaid interest thereon. The Facility Agreement does not provide for a prepayment of the Notes at our option.

Financing Derivative

A number of features embedded in the Notes to the Facility Agreement required accounting for as a derivative, including the indemnification of certain withholding taxes and the acceleration of debt upon (i) a qualified financing, (ii) an event of default, (iii) a Major Transaction, and (iv) the exercise of the warrant via offset to debt principal. These features represent a single derivative (the “Financing Derivative”) that was bifurcated from the debt instrument and accounted for as a liability at fair value, with changes in fair value between reporting periods recorded in other income (expense), net.

The estimated fair value of the Financing Derivative was determined by comparing the difference between the fair value of the Notes with and without the Financing Derivative by calculating the respective present values from future cash flows using a 10.6% and 13.5% weighted average market yield at December 31, 2016 and December 31, 2015, respectively. The estimated fair value of the Financing Derivative as of December 31, 2016 and December 31, 2015 was $0.4 million and $0.6 million, respectively.

Notes

We initially recorded the Notes and Warrants at $14.1 million and $6.4 million, respectively, based upon the relative fair value allocation of the $20.5 million of proceeds. The carrying value of the Notes at the inception of the debt was $12.8 million, resulting in an original issue discount of $7.7 million. As of December 31, 2016 and 2015, debt discount of $4.3 million and $5.4 million, respectively, remained to be amortized through February 2020, the maturity of the Notes.

As of December 31, 2016, debt payments, which include interest and principal, are as follows (in thousands):

2017	$ 1,794
2018	5,375
2019	2,816
2020	15,852
Total remaining payments	25,837
Less: interest and discounts	(9,731)

Notes payable	16,106

NOTE 7. COMMITMENTS AND CONTINGENCIES

Leases

In December 2009, we entered into a lease agreement for a manufacturing and office facility in Menlo Park. In order for the facility to meet our needs and operating requirements, substantial tenant improvements, including improvements to the structural elements and principal operating systems of the facility, were necessary. The lessor provided a tenant improvement allowance of $1.8 million to apply towards the necessary improvements and we remained obligated for additional amounts over the afforded allowance. Due to our involvement in and the nature of the renovations made to the facility and our obligations to fund the costs of renovations exceeding the incentives afforded to us, we account for the facility as if we are the owner. Accordingly, we recorded $3.0 million of building and leasehold improvement assets, reflecting the $1.2 million fair value of the facility prior to commencing renovations and the $1.8 million of landlord incentives within property and equipment, net and a corresponding liability recorded to facility financing obligation.

As a result of the lease amendment agreement described below, future rent expense associated with our existing Menlo Park facility leases was reduced to zero. The remaining long-term facility financing obligations associated with these leases, presented as “Other liabilities, non-current” on the consolidated balance sheets at December 31, 2016 and December 31, 2015, were $1.7 million and $1.4 million, respectively.

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Lease Amendment Agreement

On July 23, 2015, we entered into a Lease Amendment Agreement (the "Lease Amendment Agreement") with Peninsula Innovation Partners, LLC (the "Existing Landlord"), which amends the terms and conditions of certain of our existing Menlo Park facility real property leases. The Lease Amendment Agreement provides for, among other things, amendments of the term for certain of the leases with the Existing Landlord, the termination of all renewal, expansion and extension rights contained in any of the existing leases with the Existing Landlord (including our options to extend the terms for certain of the existing leases for two consecutive five-year periods), as well as rent abatement for a specified period of time. As consideration for our agreement to amend the existing leases pursuant to the Lease Amendment Agreement, and subject to the terms and conditions contained therein, we became eligible to receive up to four payments of $5.0 million each from the Existing Landlord over time (the "Landlord Payments"), and rent abatement for the remainder of the lease. In the event that we breach any of the leases and fail to cure such breach within the time permitted, the Existing Landlord would have no obligation to make the final $5.0 million payment. On September 1, 2015, the permit process related to an architectural approval and a change of use permit with respect to our new premises at 1305 O'Brien Drive (formerly 1315 O'Brien Drive), Menlo Park, California (the "O'Brien Premises") was completed, which satisfied the contingencies under the Lease Amendment Agreement. As a result, we recorded $23.0 million in "Gain on lease amendments" in the consolidated statements of operations and comprehensive loss for the three-month period ended September 30, 2015, reflecting that our rent payments were reduced to zero for the remaining term of our existing Menlo Park facility real property leases, and the aggregate of $20.0 million in Landlord Payments became receivable and any associated financing obligation was revalued. Of the $20.0 million remaining Landlord Payments, the first $5.0 million Landlord Payment was received in September 2015, the second $5.0 million Landlord Payment was received in February 2016 and the third $5.0 million Landlord Payment was received in August 2016.

In June 2016, we entered into a Second Lease Amendment Agreement with the Existing Landlord that modified the payment schedule for the final $5.0 million. At December 31, 2016, the final $5.0 million was recorded in "Prepaid Expenses and Other Current Assets" in the consolidated balance sheets. We do not believe that there are any remaining performance obligations relating to the remaining Landlord Payments. In January 2017, we entered into a Third Lease Amendment Agreement with the Existing Landlord that increased the amount of the payments receivable from the Existing Landlord by $65,000. In February 2017, we received $1,045,000 out of the total receivable of $5,065,000 from the Existing Landlord.

O'Brien Lease Agreement

On July 22, 2015, we entered into a new lease agreement (the "O'Brien Lease") with respect to the O'Brien Premises. The term of the O'Brien Lease is one hundred thirty-two (132) months, commencing on the date that is the later of April 15, 2016 or the date on which the O'Brien Premises landlord has substantially completed certain shell improvements and tenant improvements. In December 2016, we entered into an amendment to the O'Brien Lease which defined the commencement date of the lease to be October 25, 2016, notwithstanding that such substantial completion date had not yet occurred. We did not have control of the building until after December 31, 2016. Base monthly rent will be abated for the first six (6) months of the lease term and thereafter will be $540,000 per month during the first year of the lease term, with specified annual increases thereafter until reaching $711,000 per month during the last twelve (12) months of the lease term. We were required to pay $2,160,000 in prepaid rent which will be applied to the monthly rent installments due for the first to fourth months after the rent abatement period. We were required to establish a deposit of $4.5 million in the form of a letter of credit in October 2015; and, as such, $4.5 million was recorded in "Long-term restricted cash" in the consolidated balance sheet as of both December 31, 2016 and December 31, 2015. The landlord is obligated to construct certain shell improvements at the landlord's cost and expense and provide us with improvement allowances in the amount of $12.6 million.

Under the O'Brien Lease, we expect to pay approximately $79.2 million in rent and $24.0 million in operating expenses over the expected lease term. In addition to the lease payments, we are also required to reimburse the landlord for certain improvement costs in excess of the tenant improvement allowances provided. These improvement costs, along with the costs associated with the anticipated move to the O'Brien Premises, are expected to be substantial in nature. These future expenditures are expected to be partially offset by the $5.1 million of future Landlord Payments from our Existing Landlord as described above.

As of December 31, 2016, the future annual minimum lease payments under all noncancelable operating leases with remaining term in excess of one year are as follows:

Years ending December 31,	Amount (in thousands)
2017	$ 4,569
2018	6,949
2019	6,930
2020	7,056
2021	7,272
Thereafter	46,710
Total minimum lease payments	$ 79,486

Rent expense for the years ended December 31, 2016, 2015 and 2014 was $0.2 million, $1.1 million and $2.2 million, respectively. Rent expense decreased for the year ended December 31, 2016 due to the rent abatements in 2016. We are also required to pay our share of operating expenses with respect to the facilities in which we operate.

In addition, we have other purchase commitments of an estimated amount of approximately $18.0 million consisting of open purchase orders and contractual obligations in the ordinary course of business, including commitments with contract manufacturers and suppliers for which we have not received the goods or services, and acquisition and licensing of intellectual property. A majority of these purchase obligations are due within a year. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

Contingencies

We become subject to claims and assessments from time to time in the ordinary course of business. We accrue liabilities for such matters when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Legal Proceedings

On November 2, 2016, we filed a complaint against Oxford Nanopore Technologies Ltd., Oxford Nanopore Technologies, Inc. and Metrichor, Ltd. (together, "ONT") with the U.S. International Trade Commission ("USITC") for patent infringement. On December 5, 2016, the USITC provided notice that an investigation had been instituted based on the complaint. We are seeking exclusionary relief with respect to several ONT products, including ONT's MinION and PromethION devices. The complaint is based on our U.S. Patent No. 9,404,146, entitled "Compositions and methods for nucleic acid sequencing" which covers novel methods for sequencing single nucleic acid molecules using linked double-stranded nucleic acid templates, providing improved sequencing accuracy. On March 1, 2017, e filed an amendment complaint to add a second patent in the same patent family, U.S. Patent No. 9,542,527, which was granted on January 10, 2017, to the investigation. We are seeking, among other things, an exclusion order permanently barring entry of infringing ONT products into the United States, and a cease and desist order preventing ONT from advertising and selling infringing products in the United States. The estimated financial effect associated with this complaint cannot be made as of this 10-K filing time.

On February 2, 2017, we filed a claim in the High Court of England and Wales against Oxford Nanopore Technologies Ltd. and Metrichor, Ltd. for infringement of Patent EP(UK) 3 025 542, which is in the same patent family as the patents asserted in the USITC action referred to above. We are seeking remedies including injunctive relief, damages, and costs.

From time to time, we may also be involved in a variety of other claims, lawsuits, investigations and proceedings relating to securities laws, product liability, patent infringement, contract disputes, employment and other matters that arise in the normal course of our business. In addition, third parties may, from time to time, assert claims against us in the form of letters and other communications. We record a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We currently do not believe that the ultimate outcome of any of the matters described above is probable or reasonably estimable, or that these matters will have a material adverse effect on our business; however, the results of litigation and claims are inherently unpredictable. Regardless of the outcome, litigation can have an adverse impact on us because of litigation and settlement costs, diversion of management resources and other factors.

Indemnification

Pursuant to Delaware law and agreements entered into with each of our directors and officers, we may have obligations, under certain circumstances, to hold harmless and indemnify each of our directors and officers against losses suffered or incurred by the indemnified party in connection with their service to us, and judgments, fines, settlements and expenses related to claims arising against such directors and officers to the fullest extent permitted under Delaware law, our bylaws and certificate of incorporation. We also enter and have entered into indemnification agreements with our directors and officers that may require us to indemnify them against liabilities that arise by reason of their status or service as directors or officers, except as prohibited by applicable law. In addition, we may have obligations to hold harmless and indemnify third parties involved with our fund raising efforts and their respective affiliates, directors, officers, employees, agents or other representatives against any and all losses, claims, damages and liabilities related to claims arising against such parties pursuant to the terms of agreements entered into between such third parties and us in connection with such fund raising efforts. To the extent that any such indemnification obligations apply to the lawsuits described above, any associated expenses incurred are included within the related accrued litigation expense amounts. No additional liability associated with such indemnification obligations has been recorded at December 31, 2016.

NOTE 8. INCOME TAXES

A reconciliation between the statutory federal income tax and our effective tax rates as a percentage of loss before income taxes are as follows: