Inogen Inc
Form 10-Q
August 07, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

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: 001-36309

INOGEN, INC.

(Exact name of registrant as specified in its charter)

Delaware	33-0989359
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
326 Bollay Drive Goleta, California	93117
(Address of principal executive offices)	(Zip Code)

(805) 562-0500

(Registrant’s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed 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 No

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 31, 2018, the registrant had 21,350,470 shares of common stock, par value $0.001, outstanding.

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INOGEN, INC.

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Inogen, Inc.

Consolidated Balance Sheets

(amounts in thousands)

	June 30, 2018 (unaudited)	December 31, 2017
Assets		
Current assets		
Cash and cash equivalents	$ 166,344	$ 142,953
Marketable securities	42,068	30,991
Accounts receivable, net	37,472	31,444
Inventories, net	27,407	18,842
Deferred cost of revenue	381	361
Income tax receivable	2,655	1,313
Prepaid expenses and other current assets	6,667	2,584
Total current assets	282,994	228,488
Property and equipment		
Rental equipment, net	46,638	49,349
Manufacturing equipment and tooling	7,272	6,858
Computer equipment and software	6,138	5,484
Furniture and equipment	975	746
Leasehold improvements	2,098	1,598
Land and building	125	125
Construction in process	3,069	408
Total property and equipment	66,315	64,568
Less accumulated depreciation	(44,343)	(44,465)
Property and equipment, net	21,972	20,103
Goodwill	2,304	2,363
Intangible assets, net	4,093	4,717
Deferred tax asset - noncurrent	20,736	18,636
Other assets	537	765
Total assets	$ 332,636	$ 275,072

See accompanying condensed notes to the consolidated financial statements.

Inogen, Inc.

Consolidated Balance Sheets (continued)

(amounts in thousands, except share and per share amounts)

	June 30, 2018 (unaudited)	December 31, 2017
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable and accrued expenses	$ 31,174	$ 20,626
Accrued payroll	9,108	6,877
Warranty reserve - current	3,223	2,505
Deferred revenue - current	3,383	3,533
Income tax payable	344	345
Total current liabilities	47,232	33,886
Long-term liabilities		
Warranty reserve - noncurrent	5,507	3,666
Deferred revenue - noncurrent	11,713	9,402
Deferred tax liability - noncurrent	340	348
Other noncurrent liabilities	938	729
Total liabilities	65,730	48,031
Commitments and contingencies (Note 8)		
Stockholders' equity		
Common stock, $0.001 par value per share; 200,000,000 authorized; 21,321,543 and 20,976,350 shares issued and outstanding as of June 30, 2018 and December 31, 2017, respectively	21	21
Additional paid-in capital	231,879	218,109
Retained earnings	34,007	8,639
Accumulated other comprehensive income	999	272
Total stockholders' equity	266,906	227,041
Total liabilities and stockholders' equity	$ 332,636	$ 275,072

See accompanying condensed notes to the consolidated financial statements.

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Inogen, Inc.

Consolidated Statements of Comprehensive Income

(unaudited)

(amounts in thousands, except share and per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Revenue				
Sales revenue	$91,987	$58,038	$165,571	$104,004
Rental revenue	5,251	6,083	10,718	12,617
Total revenue	97,238	64,121	176,289	116,621
Cost of revenue				
Cost of sales revenue	44,968	27,993	81,916	49,906
Cost of rental revenue, including depreciation of $1,966 and $2,522 for the three months ended and $4,131 and $5,211 for the six months ended, respectively	3,800	4,561	8,176	9,404
Total cost of revenue	48,768	32,554	90,092	59,310
Gross profit				
Gross profit-sales revenue	47,019	30,045	83,655	54,098
Gross profit-rental revenue	1,451	1,522	2,542	3,213
Total gross profit	48,470	31,567	86,197	57,311
Operating expense				
Research and development	1,775	1,260	3,191	2,569
Sales and marketing	22,999	11,945	41,037	22,474
General and administrative	9,675	9,865	19,248	18,200
Total operating expense	34,449	23,070	63,476	43,243
Income from operations	14,021	8,497	22,721	14,068
Other income (expense)				
Interest income	673	146	1,216	247
Other income (expense)	(1,048)	523	(604)	730
Total other income (expense), net	(375)	669	612	977
Income before provision (benefit) for income taxes	13,646	9,166	23,333	15,045
Provision (benefit) for income taxes	(964)	828	(2,035)	775
Net income	14,610	8,338	25,368	14,270
Other comprehensive income (loss), net of tax				
Change in foreign currency translation adjustment	76	197	184	197
Change in net unrealized gains (losses) on foreign currency hedging	723	(300)	474	(246)
Less: reclassification adjustment for net (gains) losses included in net income	(103)	49	69	(8)
	620	(251)	543	(254)

Total net change in unrealized gains (losses) on foreign currency hedging				
Change in net unrealized gains (losses) on available-for-sale investments	19	(6)	—	58
Total other comprehensive income (loss), net of tax	715	(60)	727	1
Comprehensive income	$15,325	$8,278	$26,095	$14,271
Basic net income per share attributable to common stockholders (Note 5)	$0.69	$0.40	$1.20	$0.69
Diluted net income per share attributable to common stockholders (Note 5)	$0.65	$0.38	$1.13	$0.66
Weighted-average number of shares used in calculating net income per share attributable to common stockholders:				
Basic common shares	21,172,170	20,622,320	21,099,566	20,556,293
Diluted common shares	22,503,749	21,848,359	22,409,011	21,731,592

See accompanying condensed notes to the consolidated financial statements.

Inogen, Inc.

Consolidated Statements of Stockholders' Equity

(amounts in thousands, except share amounts)

	Common stock		Additional paid-in	Retained earnings (accumulated	Accumulated other comprehensive income	Total stockholders'
	Shares	Amount	capital	deficit)	(loss)	equity
Balance, December 31, 2016	20,389,860	$ 20	$ 194,466	$ (12,363)	$ (35)	$ 182,088
Stock-based compensation	—	—	4,107	—	—	4,107
Employee stock purchases	11,805	—	581	—	—	581
Stock options exercised	308,132	1	6,729	—	—	6,730
Net income	—	—	—	14,270	—	14,270
Other comprehensive income	—	—	—	—	1	1
Balance, June 30, 2017 (unaudited)	20,709,797	$ 21	$ 205,883	$ 1,907	$ (34)	$ 207,777
Balance, December 31, 2017	20,976,350	$ 21	$ 218,109	$ 8,639	$ 272	$ 227,041
Stock-based compensation	—	—	6,567	—	—	6,567
Employee stock purchases	12,013	—	988	—	—	988
Restricted stock awards issued	53,052	—	—	—	—	—
Vesting of restricted stock units	6,665	—	—	—	—	—
Shares withheld related to net restricted stock settlement	(2,553)	—	(302)	—	—	(302)
Stock options exercised	276,016	—	6,517	—	—	6,517
Net income	—	—	—	25,368	—	25,368
Other comprehensive income	—	—	—	—	727	727
Balance, June 30, 2018 (unaudited)	21,321,543	$ 21	$ 231,879	$ 34,007	$ 999	$ 266,906

See accompanying condensed notes to the consolidated financial statements.

Inogen, Inc.

Consolidated Statements of Cash Flows

(unaudited)

(amounts in thousands)

	Six months ended June 30,	
	2018	2017
Cash flows from operating activities		
Net income	$25,368	$14,270
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,809	6,321
Loss on rental units and other fixed assets	525	604
Gain on sale of former rental assets	(401)	(50)
Provision for sales returns and doubtful accounts	9,942	6,702
Provision for rental revenue adjustments	1,429	2,903
Provision for inventory obsolescence and other inventory losses	227	102
Stock-based compensation expense	6,567	4,107
Deferred income taxes	(2,100)	662
Changes in operating assets and liabilities:		
Accounts receivable	(17,480)	(12,369)
Inventories	(9,070)	(2,154)
Deferred cost of revenue	(20)	13
Income tax receivable	(1,346)	(1,062)
Prepaid expenses and other current assets	(4,084)	(157)
Other noncurrent assets	(104)	—
Accounts payable and accrued expenses	10,830	8,466
Accrued payroll	2,235	(1,551)
Warranty reserve	2,559	1,171
Deferred revenue	2,161	2,228
Income tax payable	7	(61)
Other noncurrent liabilities	209	(34)
Net cash provided by operating activities	33,263	30,111
Cash flows from investing activities		
Purchases of available-for-sale investments	(39,312)	(22,725)
Maturities of available-for-sale investments	28,235	14,318
Investment in property and equipment	(4,541)	(969)
Production and purchase of rental equipment	(2,447)	(1,834)
Proceeds from sale of former assets	619	91
Payment for acquisition, net of cash acquired	—	(4,442)
Net cash used in investing activities	(17,446)	(15,561)

(continued on next page)

See accompanying condensed notes to the consolidated financial statements.

Inogen, Inc.

Consolidated Statements of Cash Flows (continued)

(unaudited)

(amounts in thousands)

	Six months ended June 30,	
	2018	2017
Cash flows from financing activities		
Proceeds from stock options exercised	6,517	6,730
Proceeds from employee stock purchases	988	581
Payment of employment taxes related to release of restricted stock	(302)	—
Net cash provided by financing activities	7,203	7,311
Effect of exchange rates on cash	371	(1)
Net increase in cash and cash equivalents	23,391	21,860
Cash and cash equivalents, beginning of period	142,953	92,851
Cash and cash equivalents, end of period	$166,344	$114,711
Supplemental disclosures of cash flow information		
Cash paid during the period for income taxes, net of refunds received	$1,631	$1,070
Supplemental disclosure of non-cash transactions		
Property and equipment in accounts payable and accrued liabilities	$204	$153

See accompanying condensed notes to the consolidated financial statements.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements

(unaudited)

(amounts in thousands, except share and per share amounts)

1. Business overview

Inogen, Inc. (Company or Inogen) was incorporated in Delaware on November 27, 2001. The Company is a medical technology company that primarily develops, manufactures and markets innovative portable oxygen concentrators used to deliver supplemental long-term oxygen therapy to patients suffering from chronic respiratory conditions. Traditionally, these patients have relied on stationary oxygen concentrator systems for use in the home and oxygen tanks or cylinders for mobile use, which the Company calls the delivery model. The tanks and cylinders must be delivered regularly and have a finite amount of oxygen, which requires patients to plan activities outside of their homes around delivery schedules and a finite oxygen supply. Additionally, patients must attach long, cumbersome tubing to their stationary concentrators simply to enable mobility within their homes. The Company's proprietary Inogen One® systems concentrate the air around the patient to offer a single source of supplemental oxygen anytime, anywhere with a portable device weighing approximately 2.8, 4.8 or 7.0 pounds with a single battery. The Company's Inogen One G4® and Inogen One G3® have up to 2.6 and 4.7 hours of battery life, respectively, with a single battery and can be plugged into an outlet when at home, in a car, or in a public place with outlets available. The Company's Inogen One systems reduce the patient's reliance on stationary concentrators and scheduled deliveries of tanks with a finite supply of oxygen, thereby improving patient quality of life and fostering mobility.

Portable oxygen concentrators represented the fastest-growing segment of the Medicare oxygen therapy market between 2012 and 2016. The Company estimates based on 2016 Medicare data that the number of patients using portable oxygen concentrators represents approximately 9.1% of the total addressable oxygen market in the United States, although the Medicare data does not account for private insurance and cash-pay patients in the market. Based on 2016 industry data, the Company believes it was the leading worldwide manufacturer of portable oxygen concentrators. The Company believes it is the only manufacturer of portable oxygen concentrators that employs a direct-to-consumer rental strategy in the United States, meaning the Company markets its products to patients, processes their physician paperwork, provides clinical support as needed and bills Medicare or insurance on their behalf. To pursue a direct-to-consumer rental strategy, the Company's manufacturing competitors would need to meet national accreditation and state-by-state licensing requirements and secure Medicare billing privileges, as well as compete with the home medical equipment providers who many of the Company's manufacturing competitors sell to across their entire homecare business.

Since adopting the Company's direct-to-consumer strategy in 2009, the Company has directly sold or rented more than 465,000 of its Inogen oxygen concentrators as of June 30, 2018.

The Company incorporated Inogen Europe Holding B.V., a Dutch limited liability company, on April 13, 2017. The Company owns all outstanding stock of Inogen Europe Holding B.V., which became a wholly owned subsidiary of the Company. On May 4, 2017, the Company, through its wholly owned subsidiary, Inogen Europe Holding B.V., acquired all issued and outstanding capital stock of MedSupport Systems B.V. (MedSupport).

2. Basis of presentation and summary of significant accounting policies

The accompanying consolidated financial statements are unaudited. The consolidated balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements of the Company. The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (U.S. GAAP) for interim financial information, and in management's opinion, includes all adjustments, consisting of only normal recurring adjustments, necessary for the fair statement of the Company's financial position, its results of operations, stockholders' equity and cash flows for the interim periods presented. The results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of the results to be expected for the full fiscal year or any other period.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on February 27, 2018. There have been no significant changes in the Company's accounting policies from those disclosed in its Annual Report on Form 10-K filed with the SEC on February 27, 2018.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

Basis of consolidation

The consolidated financial statements include the accounts of Inogen, Inc. and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Management bases these estimates and assumptions upon historical experience, existing and known circumstances, authoritative accounting pronouncements and other factors that management believes to be reasonable. Significant areas requiring the use of management estimates relate to revenue recognition and determining the stand-alone selling price (SSP) of performance obligations, inventory and rental asset valuations and write-downs, accounts receivable allowances for bad debts, returns and adjustments, warranty expense, stock compensation expense, depreciation and amortization, income tax provision and uncertain tax positions, fair value of financial instruments, and fair value of acquired intangible assets and goodwill. Actual results could differ from these estimates.

Revenue

The Company generates revenue primarily from sales and rentals of its products. The Company’s products consist of its proprietary line of oxygen concentrators and related accessories. Other revenue, which is included in sales revenue on the consolidated statements of comprehensive income, consists of repair services and freight revenue for product shipments.

Sales revenue

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. Revenue from product sales is generally recognized upon shipment of the product but is deferred for certain transactions when control has not yet transferred to the customer.

The Company’s product is generally sold with a right of return and the Company may provide other incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize. Returns and incentives are estimated at the time sales revenue is recognized. The provisions for estimated returns are made based on known claims and estimates of additional returns based on historical data and future expectations. Sales revenue incentives within the Company’s contracts are estimated based on the most likely amounts expected on the related sales transaction and recorded as a reduction to revenue at the time of sale in accordance with the terms of the contract. Accordingly, revenue is recognized net of allowances for estimated returns and incentives.

The Company also offers a lifetime warranty for direct-to-consumer sales of its portable concentrators. For a fixed price, the Company agrees to provide a fully functional portable oxygen concentrator for the remaining life of the patient. Lifetime warranties are only offered to patients upon the initial sale of portable oxygen concentrators by the Company and are non-transferable. Lifetime warranties are considered to be a distinct performance obligation that are accounted for separately from its sale of portable oxygen concentrators with a standard warranty of three years.

The revenue is allocated to the distinct lifetime warranty performance obligation based on a relative SSP method. The Company has vendor-specific objective evidence of the selling price for its equipment. To determine the selling price of the lifetime warranty, the Company uses its best estimate of the SSP for the distinct performance obligation as the lifetime warranty is neither separately priced nor is the selling price available through third-party evidence. To calculate the selling price associated with the lifetime warranties, management considered the profit margins of the overall business, the average estimated cost of lifetime warranties and the price of extended warranties. Revenue from the distinct lifetime warranty is deferred after the delivery of the equipment for three years and recognized on a straight-line basis during the fourth and fifth year, which is the estimated usage period of the contract based on the average patient life expectancy.

Revenue from the sale of the Company’s repair services is recognized when the performance obligations are satisfied, and collection of the receivables is probable. Other revenue from sale of replacement parts and non-warranty repair services is generally recognized when product is shipped to customers.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

Freight revenue consists of fees associated with the deployment of products internationally and domestically when expedited freight options are requested or when minimum order quantities are not met. Freight revenue is generally recognized upon shipment of the product but is deferred if control has not yet transferred to the customer. Shipping and handling costs for sold products and rental assets shipped to the Company's customers are included on the consolidated statements of comprehensive income as part of cost of sales revenue and cost of rental revenue, respectively.

The payment terms and conditions of customer contracts vary by customer type and the products and services offered. For certain products or services and customer types, the Company requires payment before the products or services are delivered to the customer. The timing of sales revenue recognition, billing and cash collection results in billed accounts receivable and deferred revenue in the consolidated balance sheet.

Contract liabilities primarily consist of deferred revenue related to lifetime warranties on direct-to-consumer sales revenue when cash payments are received in advance of services performed under the contract. The contract with the customer states the final terms of the sale, including the description, quantity, and price of each product or service purchase. The increase in deferred revenue related to lifetime warranties for the six months ended June 30, 2018 was primarily driven by $3,300 of payments received in advance of satisfying the distinct performance obligation, partially offset by $615 of revenues recognized that were included in the deferred revenue balance as of December 31, 2017. Lifetime warranties on direct-to-consumer sales revenue of $13,505 and $10,820 as of June 30, 2018 and December 31, 2017, respectively, are classified within deferred revenue – current and noncurrent deferred revenue in the consolidated balance sheet.

The Company elected to apply the practical expedient in accordance with Accounting Standards Codification (ASC) 606—Revenue Recognition and did not evaluate contracts of one year or less for the existence of a significant financing component. The Company does not expect any revenue to be recognized over a multi-year period.

The Company's sales revenue is primarily derived from the sale of its Inogen One systems, Inogen At Home systems, and related accessories to individual consumers, home medical equipment providers, distributors, the Company's private label partner and resellers worldwide. Sales revenue is classified into two areas: business-to-business sales and direct-to-consumer sales. The following table sets forth the Company's sales revenue disaggregated by sales channel and geographic region:

	Three months ended June 30,		Six months ended June 30,	
Revenue by region and category	2018	2017	2018	2017
Business-to-business domestic sales	$32,943	$21,154	$60,959	$38,615
Business-to-business international sales	20,759	14,919	37,665	26,342
Direct-to-consumer domestic sales	38,285	21,965	66,947	39,047

Total sales revenue	$91,987	$58,038	$165,571	$104,004

Rental revenue

The Company recognizes equipment rental revenue over the non-cancelable lease term, which is one month, less estimated adjustments, in accordance with ASC 840 —Leases. The Company has separate contracts with each patient that are not subject to a master lease agreement with any third-party payor. The Company evaluates the individual lease contracts at lease inception and the start of each monthly renewal period to determine if there is reasonable assurance that the bargain renewal option associated with the potential capped free rental period would be exercised. Historically, the exercise of such bargain renewal option is not reasonably assured at lease inception and most subsequent monthly lease renewal periods. If the Company determines that the reasonable assurance threshold for an individual patient is met at lease inception or at a monthly lease renewal period, such determination would impact the bargain renewal period for an individual lease. The Company would first consider the lease classification issue (sales-type lease or operating lease) and then appropriately recognize or defer rental revenue over the lease term, which may include a portion of the capped rental period.

The lease term begins on the date products are shipped to patients and are recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including Medicare, private payors, and Medicaid. Due to the nature of the industry and the reimbursement environment in which the Company operates, certain estimates are required to record net revenue and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review. The Company adjusts revenue for historical trends on revenue adjustments due to timely filings, deaths, hospice, and other types of analyzable adjustments on a monthly basis. Accounts receivable are reduced by an allowance for doubtful accounts which provides for those accounts from which payment is not expected to be received although product was delivered, and revenue was earned. The determination that an account is uncollectible, and the ultimate write-off of that account occurs once collection is considered to be not probable, and it is written-off and charged to the allowance at that time. Amounts billed but not earned due to the timing of the billing cycle are deferred and recognized in rental revenue on a straight-line basis over the monthly billing period. For example, if the first day of the billing period does not fall on the first of the month, then a portion of the monthly billing period will fall in the subsequent month and the related revenue and cost would be deferred based on the service days in the following month.

Rental revenue is recognized as upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services, less estimated adjustments. Revenue not billed at the end of the period is reviewed for the probability of collection and accrued if collection is probable. Rental revenue is not guaranteed, and payment will cease if the patient no longer needs oxygen or returns the equipment. Rental revenue is recognized at estimated allowable amounts that reflect the full consideration the Company expects to receive in exchange for the equipment; transfers to secondary insurances or patient responsibility have no net effect on revenue. Rental revenue is earned for that entire month if the patient is on service on the first day of the 30-day period commencing on the recurring date of service for a particular claim, regardless if there is a change in condition or death after that date.

Included in rental revenue are unbilled amounts for which the revenue recognition criteria had been met as of period-end but were not yet billed to the payor. The estimate of net unbilled rental revenue recognized is based on historical trends and estimates of future collectability. In addition, the Company estimates potential future adjustments and write-offs of these unbilled amounts and includes these estimates in the allowance for adjustments and write-offs of rental revenue which is netted against gross receivables.

Recently issued accounting pronouncements not yet adopted

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, Leases (Topic 842). The new guidance will require organizations that lease assets—referred to as “lessees”—to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases with lease terms of more than twelve months. This will increase the reported assets and liabilities – in some cases very significantly. ASU No. 2016-02 will take effect for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption will be permitted for all entities. In January 2018, the FASB issued ASU No. 2018-01, Land Easement Practice Expedient for Transition to Topic 842, which is an amendment to ASU No. 2016-02 that offers a practical expedient for accounting for land easements. This practice expedient allows an entity the option of not evaluating existing land easements under ASC 842. New or modified land easements will still require evaluation under ASC 842 on a prospective basis beginning on the date of adoption.

While the Company continues to evaluate the effect of adopting this guidance on the consolidated financial statements and related disclosures, the Company expects its operating leases, as disclosed in Note 8 – Commitments and contingencies, will be subject to the new standard. The Company intends to recognize right-of-use assets and operating lease liabilities on the consolidated balance sheets upon adoption, which will increase the Company's total assets and liabilities. The Company plans to adopt the standard on January 1, 2019.

In June 2016, the FASB issued ASU No. 2016-13, Accounting for Credit Losses (Topic 326). The new standard requires the use of an "expected loss" model on certain types of financial instruments. The standard also amends the impairment model for available-for-sale debt securities and requires estimated credit losses to be recorded as allowances instead of reductions to amortized cost of the securities. The ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those years, with early adoption permitted. The Company is evaluating the new guidance but does not expect it to have a material impact on the Company's consolidated financial statement presentation or results.

In January 2017, the FASB issued ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. The new guidance eliminates step two of the goodwill impairment test. Under the new guidance, an entity should recognize an impairment charge for the amount by which a reporting unit's carrying value exceeds its fair value. The ASU is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is currently evaluating the effect of the new guidance but does not expect it to have a material impact on the Company's consolidated financial statement presentation or results.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging, which changes both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results, in order to better align an entity's risk management activities and financial reporting for hedging relationships. The amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. ASU No. 2017-12 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods, with early adoption permitted. The Company is still evaluating the impact that this guidance will have on the Company's consolidated financial statement presentation or results and has not yet determined whether the Company will early adopt ASU No. 2017-12.

In January 2018, the FASB issued ASU No. 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The new guidance permits entities the option to reclassify tax effects that are stranded in accumulated other comprehensive income as a result of the implementation of the Tax Cuts and Jobs Act to retained earnings. The Company intends to adopt the standard on January 1, 2019 and does not expect it to have a material impact on the Company's consolidated financial statement presentation or results.

In June 2018, the FASB issued ASU No. 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. The new guidance modifies the accounting for nonemployee share-based payments. The Company intends to adopt the standard on January 1, 2019 and does not currently have an impact on the Company's consolidated financial statement presentation or results.

Recently adopted accounting pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU No. 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU No. 2014-09 defines a five-step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. In March 2016, the FASB issued ASU No. 2016-08, Revenue with Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which is an amendment to ASU No. 2014-09 that improved the operability and understandability of implementation guidance versus agent considerations by clarifying the determination of principal versus agent. The Company completed its adoption plan including assessment of the Company's revenue streams and analysis of all outstanding contracts by application of the five-step model to those contracts and revenue streams. The Company adopted the standard on January 1, 2018, using the modified retrospective method. The Company finalized its analysis and the adoption of this standard did not have a material impact on the consolidated financial statements and internal controls over financial reporting.

In January 2017, the FASB issued ASU No. 2017-01, Clarifying the Definition of a Business. The new guidance revises the definition of a business and provides new guidance in evaluating when a set of transferred assets and activities is a business. The Company adopted this standard on January 1, 2018. The adoption of this ASU did not

have a material effect on the Company's consolidated financial statement presentation or results.

Business segments

The Company operates and reports in only one operating and reportable segment – development, manufacturing, marketing, sales, and rental of respiratory products. Management reports financial information on a consolidated basis to the Company's chief operating decision maker.

3. Fair value of financial instruments

The Company's financial instruments consist of cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued expenses. The carrying values of its financial instruments approximate fair value based on their short-term nature.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

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(amounts in thousands, except share and per share amounts)

Fair value accounting

Accounting Standards Codification (ASC) 820 — Fair Value Measurements and Disclosures, creates a single definition of fair value, establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. ASC 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Assets and liabilities adjusted to fair value in the balance sheet are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs, as defined by ASC 820, are as follows:

Level input	Input definition
Level 1	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level 2	Inputs, other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with market data at the measurement date.
Level 3	Unobservable inputs that reflect management’s best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The Company obtained the fair value of its available-for-sale investments, which are not in active markets, from a third-party professional pricing service using quoted market prices for identical or comparable instruments, rather than direct observations of quoted prices in active markets. The Company's professional pricing service gathers observable inputs for all of its fixed income securities from a variety of industry data providers (e.g., large custodial institutions) and other third-party sources. Once the observable inputs are gathered, all data points are considered, and the fair value is determined. The Company validates the quoted market prices provided by its primary pricing service by comparing their assessment of the fair values against the fair values provided by its investment managers. The Company's investment managers use similar techniques to its professional pricing service to derive pricing as described above. As all significant inputs were observable, derived from observable information in the marketplace or supported by observable levels at which transactions are executed in the marketplace, the Company has classified its available-for-sale investments within Level 2 of the fair value hierarchy.

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(amounts in thousands, except share and per share amounts)

The following table summarizes fair value measurements by level for the assets measured at fair value on a recurring basis for cash, cash equivalents and marketable securities:

	As of June 30, 2018				
	Adjusted cost	Gross unrealized gains/(losses)	Fair value	Cash and cash equivalents	Marketable securities
Cash	$45,660	$ —	$45,660	$ 45,660	$ —
Level 1:					
Money market accounts	120,684	—	120,684	120,684	—
Level 2:					
Certificates of deposit	1,476	(1)	1,475	—	1,475
Corporate bonds	18,141	(27)	18,114	—	18,114
U.S. Treasury securities	22,474	5	22,479	—	22,479
Total	$208,435	$ (23)	$208,412	$ 166,344	$ 42,068

	As of December 31, 2017				
	Adjusted cost	Gross unrealized losses	Fair value	Cash and cash equivalents	Marketable securities
Cash	$46,237	$ —	$46,237	$ 46,237	$ —
Level 1:					
Money market accounts	93,430	—	93,430	93,430	—
Level 2:					
Certificates of deposit	11,010	(4)	11,006	490	10,516
Corporate bonds	20,789	(21)	20,768	2,796	17,972
Agency mortgage-backed securities	2,005	(1)	2,004	—	2,004
U.S. Treasury securities	499	—	499	—	499
Total	$173,970	$ (26)	$173,944	$ 142,953	$ 30,991

The following table summarizes the estimated fair value of the Company’s investments in marketable securities, accounted for as available-for-sale securities and classified by the contractual maturity date of the securities:

	June 30, 2018
Due within one year	$42,068

Derivative instruments and hedging activities

The Company transacts business in foreign currencies and has international sales and expenses denominated in foreign currencies, subjecting the Company to foreign currency risk. The Company has entered into foreign currency forward contracts, generally with maturities of twelve months or less, to reduce the volatility of cash flows primarily related to forecasted revenue denominated in certain foreign currencies. These contracts allow the Company to sell Euros in exchange for U.S. dollars at specified contract rates. Forward contracts are used to hedge forecasted sales over specific months. Changes in the fair value of these forward contracts designed as cash flow hedges are recorded as a component of accumulated other comprehensive income (loss) within stockholders' equity and are recognized in the consolidated statements of comprehensive income during the period which approximates the time the corresponding sales occur. The Company may also enter into foreign exchange contracts that are not designated as hedging instruments for financial accounting purposes. These contracts are generally entered into to offset the gains and losses on certain asset and liability balances until the expected time of repayment. Accordingly, any gains or losses resulting from changes in the fair value of the non-designated contracts are reported in other expense, net in the consolidated statements of comprehensive income. The gains and losses on these contracts generally offset the gains and losses associated with the underlying foreign currency-denominated balances, which are also reported in other income (expense), net.

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The Company records the assets or liabilities associated with derivative instruments and hedging activities at fair value based on Level 2 inputs in other current assets or other current liabilities, respectively, in the consolidated balance sheet. The Company had a related receivable of $739 and a payable of $66 as of June 30, 2018 and December 31, 2017, respectively. The Company classifies the foreign currency derivative instruments within Level 2 in the fair value hierarchy as the valuation inputs are based on quoted prices and market observable data of whether it is designated and qualifies for hedge accounting.

The Company documents the hedging relationship and its risk management objective and strategy for undertaking the hedge, the hedging instrument, the hedged transaction, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed prospectively and retrospectively, and a description of the method used to measure ineffectiveness. The Company assesses hedge effectiveness and ineffectiveness at a minimum quarterly but may assess it monthly. For derivative instruments that are designed and qualify as part of a cash flow hedging relationship, the effective portion of the gain or loss on the derivative is reported in other comprehensive income and reclassified into earnings in the same periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current period earnings.

The Company will discontinue hedge accounting prospectively when it determines that the derivative is no longer effective in offsetting cash flows attributable to the hedge risk. The cash flow hedge is de-designated because a forecasted transaction is not probable of occurring, or management determines to remove the designation of the cash flow hedge. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Company continues to carry the derivative at its fair value on the balance sheet and recognizes any subsequent changes in the fair value in earnings. When it is probable that a forecasted transaction will not occur, the Company will discontinue hedge accounting and recognize immediately in earnings gains and losses that were accumulated in other comprehensive income related to the hedging relationship.

Accumulated other comprehensive income

The components of accumulated other comprehensive income were as follows:

	Foreign currency translation adjustments	Unrealized losses on available-for-sale investments	Unrealized gains (losses) on cash flow hedges	Accumulated other comprehensive income
Balance as of December 31, 2017	$ 363	$ (17)	$ (74)	$ 272
Other comprehensive gain	184	—	543	727
Balance as of June 30, 2018	$ 547	$ (17)	$ 469	$ 999

Comprehensive income is the total net earnings and all other non-owner changes in equity. Except for net income and unrealized gains and losses on cash flow hedges and available-for-sale investments, the Company does not have any transactions or other economic events that qualify as comprehensive income.

4. Balance sheet components

Cash, cash equivalents and marketable securities

The Company considers all short-term highly liquid investments with a maturity of three months or less to be cash equivalents. Cash equivalents are recorded at cost plus accrued interest, which is considered adjusted cost, and approximates fair value. Certificates of deposit and agency mortgage-backed securities are included in cash equivalents and marketable securities based on the maturity date of the security. Short-term investments are included in marketable securities in the current period presentation.

The Company considers investments with maturities greater than three months, but less than one year, to be marketable securities. Investments are classified as available-for-sale and are reported at fair value with unrealized gains or losses, if any, reported, net of tax, in accumulated other comprehensive income (loss). All income generated and realized gains or losses from investments are recorded to other income (expense).

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(amounts in thousands, except share and per share amounts)

The Company reviews its investments to identify and evaluate investments that have an indication of possible impairment. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Credit losses and other-than-temporary impairments are declines in fair value that are not expected to recover and are charged to other income (expense), net. Cash, cash equivalents and marketable securities consist of the following:

Cash and cash equivalents	June 30, 2018	December 31, 2017
Cash	$45,660	$46,237
Money market accounts	120,684	93,430
Certificates of deposit	—	490
Corporate bonds	—	2,796
Total cash and cash equivalents	$166,344	$142,953
Marketable securities		
Certificates of deposit	$1,475	$10,516
Corporate bonds	18,114	17,972
Agency mortgage-backed securities	—	2,004
U.S. Treasury securities	22,479	499
Total marketable securities	$42,068	$30,991

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

Accounts receivable are customer obligations due under normal sales and rental terms. The Company performs credit evaluations of the customers’ financial condition and generally does not require collateral. The allowance for doubtful accounts is maintained at a level that, in management’s opinion, is adequate to absorb potential losses related to accounts receivable and is based upon the Company’s continuous evaluation of the collectability of outstanding balances. Management’s evaluation takes into consideration such factors as past bad debt experience, economic conditions and information about specific receivables. The Company’s evaluation also considers the age and composition of the outstanding amounts in determining their net realizable value.

The allowance for doubtful accounts is based on estimates, and ultimate losses may vary from current estimates. As adjustments to these estimates become necessary, they are reported in earnings in the periods in which they become known. This allowance is increased by bad debt provisions charged to bad debt expense, net of recoveries, in operating expense and is reduced by direct write-offs.

The Company generally does not allow returns from providers for reasons not covered under its standard warranty. Therefore, provision for sales returns applies primarily to direct-to-consumer sales. This reserve is calculated based on actual historical return rates under the Company's 30-day return program and is applied to the related sales revenue for the last month of the quarter reported.

The Company also records an allowance for rental revenue adjustments which is recorded as a reduction of rental revenue and net rental accounts receivable balances. These adjustments result from contractual adjustments, audit adjustments, untimely claims filings, or billings not paid due to another provider performing same or similar functions for the patient in the same period, all of which prevent billed revenue from becoming realizable. The allowance is based on historical revenue adjustments as a percentage of rental revenue billed and unbilled during the related period.

When recording the allowance for doubtful accounts, the bad debt expense account (general and administrative expense account) is charged; when recording allowance for sales returns, the sales returns account (contra sales revenue account) is charged; and when recording the allowance for rental reserve adjustments, the rental revenue adjustments account (contra rental revenue account) is charged.

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As of June 30, 2018 and December 31, 2017, included in accounts receivable on the consolidated balance sheets were earned but unbilled receivables of $1,251 and $1,470, respectively. These balances reflect gross unbilled receivables prior to any allowances for adjustments and write-offs. The Company consistently applies its allowance estimation methodology from period-to-period. The Company's best estimate is made on an accrual basis and adjusted in future periods as required. Any adjustments to the prior period estimates are included in the current period. As additional information becomes known, the Company adjusts its assumptions accordingly to change its estimate of the allowance.

Gross accounts receivable balance concentrations by major category as of June 30, 2018 and December 31, 2017 were as follows:

Gross accounts receivable	June 30, 2018	December 31, 2017
Rental [1]	$5,451	$ 6,236
Business-to-business & other receivables [2]	35,943	28,474
Total gross accounts receivable	$41,394	$ 34,710

Net accounts receivable (gross accounts receivable, net of allowances) balance concentrations by major category as of June 30, 2018 and December 31, 2017 were as follows:

Net accounts receivable	June 30, 2018	December 31, 2017
Rental [1]	$3,240	$ 4,212
Business-to-business & other receivables [2]	34,232	27,232
Total net accounts receivable	$37,472	$ 31,444

(1) Rental includes Medicare, Medicaid/other government, private insurance and patient pay.

(2) Business-to-business receivables included one customer with a gross accounts receivable balance of $10,763 and $10,394 as of June 30, 2018 and December 31, 2017, respectively. This customer received extended payment terms through a direct financing plan offered. The Company also has a credit insurance policy in place, which allocated up to $18,000 in coverage as of June 30, 2018 and allocated up to $12,000 in coverage as of December 31, 2017 for this customer with a $400 deductible and 10% retention.

The following tables set forth the accounts receivable allowances as of June 30, 2018 and December 31, 2017:

Allowances - accounts receivable	June 30, 2018	December 31, 2017
Doubtful accounts	$1,356	$ 1,415
Rental revenue adjustments	1,081	947
Sales returns	1,485	904
Total allowances - accounts receivable	$3,922	$ 3,266

Concentration of credit risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash, cash equivalents, marketable securities and accounts receivable. At times, cash account balances may be in excess of the amounts insured by the Federal Deposit Insurance Corporation (FDIC). However, management believes the risk of loss to be minimal. The Company performs periodic evaluations of the relative credit standing of these institutions and has not experienced any losses on its cash and cash equivalents to date. The Company has entered into hedging relationships with a single counterparty to offset the forecasted Euro-based revenues. The credit risk has been reduced due to a net settlement arrangement whereby the Company is allowed to net settle transactions with a single net amount payable by one party to the other.

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Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

Concentration of customers and vendors

The Company primarily sells its products to traditional home medical equipment providers, distributors, and resellers in the United States and in foreign countries on a credit basis. The Company also sells its products direct-to-consumers on a primarily prepayment basis. One single customer represented more than 10% of the Company's total revenue for the six months ended June 30, 2018 and June 30, 2017. Two customers with accounts receivable balances of $10,763 and $6,484, respectively, each represented more than 10% of the Company's net accounts receivable balance as of June 30, 2018, and two customers with accounts receivable balances of $10,394 and $6,459, respectively, each represented more than 10% of the Company's net accounts receivable balance as of December 31, 2017.

The Company currently purchases raw materials from a limited number of vendors, which resulted in a concentration of three major vendors. The three major vendors supply the Company with raw materials used to manufacture the Company's products. For the six months ended June 30, 2018, the Company's three major vendors accounted for 20.2%, 13.8%, and 9.3%, respectively, of total raw material purchases. For the six months ended June 30, 2017, the Company's three major vendors accounted for 18.6%, 14.6% and 9.8%, respectively, of total raw material purchases.

A portion of revenue is earned from sales outside the United States. Approximately 76.0% and 75.4% of the non-U.S. revenue for the three months ended June 30, 2018 and June 30, 2017, respectively, were invoiced in Euros. Approximately, 76.4% and 73.9% of the non-U.S. revenue for the six months ended June 30, 2018 and June 30, 2017, respectively, were invoiced in Euros. A breakdown of the Company's revenue from U.S. and non-U.S. sources for the three and six months ended June 30, 2018 and June 30, 2017 is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
U.S. revenue	$76,479	$49,202	$138,624	$90,279
Non-U.S. revenue	20,759	14,919	37,665	26,342
Total revenue	$97,238	$64,121	$176,289	$116,621

Inventories

Inventories are stated at the lower of cost and net realizable value. Cost is determined using a standard cost method, including material, labor and manufacturing overhead, whereby the standard costs are updated at least quarterly to reflect approximate actual costs using the first-in, first-out (FIFO) method. The Company records adjustments at least quarterly to inventory for potentially excess, obsolete, slow-moving or impaired items. The Company recorded

noncurrent inventory related to inventories that are expected to be realized or consumed after one year of $312 and $644 as of June 30, 2018 and December 31, 2017, respectively. Noncurrent inventories are primarily related to raw materials purchased in bulk to support long-term expected repairs to reduce costs and are classified in other assets. Inventories that are considered current consist of the following:

	June 30, 2018	December 31, 2017
Raw materials and work-in-progress	$22,866	$ 16,324
Finished goods	5,145	2,917
Less: reserves	(604)	(399)
Inventories	$27,407	$ 18,842

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(amounts in thousands, except share and per share amounts)

Property and equipment

Property and equipment are stated at cost. Depreciation and amortization are calculated using the straight-line method over the assets' estimated useful lives as follows:

Rental equipment	1.5-5 years
Manufacturing equipment and tooling	2-5 years
Computer equipment and software	2-3 years
Furniture and equipment	3-5 years
Leasehold improvements	Lesser of estimated useful life or remaining lease term

Expenditures for additions, improvements and replacements are capitalized and depreciated to a salvage value of $0. Repair and maintenance costs on rental equipment are included in cost of rental revenue on the consolidated statements of comprehensive income. Repair and maintenance expense, which includes labor, parts and freight, for rental equipment was $630 and $694 for the three months ended June 30, 2018 and June 30, 2017, respectively, and $1,190 and $1,345 for the six months ended June 30, 2018 and June 30, 2017, respectively.

Included within property and equipment is construction in process, primarily related to the design and engineering of tooling, jigs and other machinery. In addition, this item also includes computer software or development costs that have been purchased but have not completed the final configuration process for implementation into the Company's systems. These items have not been placed in service; therefore, no depreciation or amortization was recognized for these items in the respective periods.

Depreciation and amortization expense related to rental equipment and other property and equipment are summarized below for the three and six months ended June 30, 2018 and June 30, 2017, respectively.

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Rental equipment	$1,966	$2,522	$4,131	$5,211
Other property and equipment	551	470	1,081	958
Total depreciation and amortization	$2,517	$2,992	$5,212	$6,169

Property and equipment and rental equipment with associated accumulated depreciation are summarized below for June 30, 2018 and December 31, 2017, respectively.

Property and equipment	June 30, 2018	December 31, 2017
Rental equipment, net of allowances of $764 and $754, respectively	$46,638	$ 49,349
Other property and equipment	19,677	15,219
Property and equipment	66,315	64,568
Accumulated depreciation		
Rental equipment	33,822	34,754
Other property and equipment	10,521	9,711
Accumulated depreciation	44,343	44,465
Property and equipment, net		
Rental equipment, net of allowances of $764 and $754, respectively	12,816	14,595
Other property and equipment	9,156	5,508
Property and equipment, net	$21,972	$ 20,103

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Condensed Notes to the Consolidated Financial Statements (continued)

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Long-lived assets

The Company accounts for the impairment and disposition of long-lived assets in accordance with ASC 360 — Property, Plant, and Equipment. In accordance with ASC 360, long-lived assets to be held are reviewed for events or changes in circumstances that indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying value of long-lived assets to determine whether or not impairment to such value has occurred. No impairments were recorded during the three months or six months ended June 30, 2018 and June 30, 2017.

Goodwill

The changes in the carrying amount of goodwill for the six months ended June 30, 2018 were as follows:

Balance as of December 31, 2017	$2,363
Translation adjustment	(59)
Balance as of June 30, 2018	$2,304

Intangible assets

There were no impairments recorded related to the Company’s intangible assets during the three months or six months ended June 30, 2018 and June 30, 2017. Amortization expense for intangible assets for the three months ended June 30, 2018 and June 30, 2017 was $299 and $125, respectively, and for the six months ended June 30, 2018 and June 30, 2017 was $597 and $152, respectively.

The following tables represent the net carrying values of intangible assets as of the respective dates:

June 30, 2018	Average estimated useful lives (in years)	Gross carrying amount	Accumulated amortization	Net amount
Licenses	10	$ 185	$ 146	$ 39
Patents and websites	5	4,173	1,304	2,869
Customer relationships	4	1,402	409	993
Non-compete agreement	2.3	233	91	142
Commercials	2-3	303	253	50
Total		$ 6,296	$ 2,203	$ 4,093

December 31, 2017	Average estimated useful lives (in years)	Gross carrying amount	Accumulated amortization	Net amount
Licenses	10	$ 185	$ 137	$ 48
Patents and websites	5	4,173	959	3,214
Customer relationships	4	1,437	240	1,197
Non-compete agreement	3	240	52	188
Commercials	2-3	303	233	70
Total		$ 6,338	$ 1,621	$ 4,717

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Annual estimated amortization expense for intangibles for each of the succeeding fiscal years is summarized as follows:

	June 30, 2018
Remaining 6 months of 2018	$617
2019	1,126
2020	1,022
2021	783
2022	545
Thereafter	—
	$4,093

Current liabilities

Accounts payable and accrued expenses as of June 30, 2018 and December 31, 2017 consisted of the following:

	June 30, 2018	December 31, 2017
Accounts payable	$17,823	$ 9,541
Accrued inventory (in-transit and unvouchered receipts) and trade payables	9,519	7,252
Accrued purchasing card liability	2,567	2,381
Accrued franchise, sales and use taxes	491	479
Other accrued expenses	774	973
Accounts payable and accrued expenses	$31,174	$ 20,626

Accrued payroll as of June 30, 2018 and December 31, 2017 consisted of the following:

	June 30, 2018	December 31, 2017
Accrued bonuses	$3,592	$ 3,086
Accrued wages and other payroll related items	2,685	1,746

Accrued vacation	1,767	1,338
Accrued employee stock purchase plan deductions	1,064	707
Accrued payroll	$9,108	$ 6,877

5. Earnings per share

Earnings per share (EPS) is computed in accordance with ASC 260—Earnings per Share and is calculated using the weighted-average number of common shares outstanding during each period. Diluted EPS assumes the conversion, exercise or issuance of all potential common stock equivalents (which can include dilution of outstanding stock options, restricted stock units and restricted stock awards) unless the effect is to reduce a loss or increase the income per share. For purposes of this calculation, common stock subject to repurchase by the Company, options are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

Basic earnings per share is calculated using the Company’s weighted-average outstanding common shares. Diluted earnings per share is calculated using the Company’s weighted-average outstanding common shares including the dilutive effect of stock awards as determined under the treasury stock method.

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The computation of EPS is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Numerator—basic and diluted:				
Net income	$14,610	$8,338	$25,368	$14,270
Denominator:				
Weighted-average common shares - basic common stock [1]	21,172,170	20,622,320	21,099,566	20,556,293
Weighted-average common shares - diluted common stock	22,503,749	21,848,359	22,409,011	21,731,592
Net income per share - basic common stock	$0.69	$0.40	$1.20	$0.69
Net income per share - diluted common stock	$0.65	$0.38	$1.13	$0.66
Denominator calculation from basic to diluted:				
Weighted-average common shares - basic common stock [1]	21,172,170	20,622,320	21,099,566	20,556,293
Stock options and other dilutive awards	1,331,579	1,226,039	1,309,445	1,175,299
Weighted-average common shares - diluted common stock	22,503,749	21,848,359	22,409,011	21,731,592
Shares excluded from diluted weighted-average shares:				
Stock options	—	64,498	—	69,498
Restricted stock units and restricted stock awards	25,194	—	83,517	5,700
Shares excluded from diluted weighted-average shares	25,194	64,498	83,517	75,198

(1) Unvested restricted stock units and restricted stock awards are not included as shares outstanding in the calculation of basic earnings per share. Vested restricted stock units and restricted stock awards are included in basic earnings per share if all vesting and performance criteria have been met. Performance-based restricted stock units and restricted stock awards are included in the number of shares used to calculate diluted earnings per share as long as all applicable performance criteria are met, and their effect is dilutive. Restricted stock awards are eligible to receive all dividends declared on the Company’s common shares during the vesting period; however, such dividends are not paid until the restrictions lapse.

The computations of diluted net income attributable to common stockholders exclude common stock options, restricted stock units and restricted stock awards, which were anti-dilutive for the three months and six months ended June 30, 2018 and June 30, 2017, respectively.

6. Income taxes

The Company accounts for income taxes in accordance with ASC 740—Income Taxes. Under ASC 740, income taxes are recognized for the amount of taxes payable or refundable for the current period and deferred tax liabilities and assets are recognized for the future tax consequences of transactions that have been recognized in the Company's consolidated financial statements or tax returns. A valuation allowance is provided when it is more likely than not that some portion, or all, of the deferred tax asset will not be realized.

The Company accounts for uncertainties in income tax in accordance with ASC 740-10—Accounting for Uncertainty in Income Taxes. ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This accounting standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company recognizes interest and penalties on taxes, if any, within its income tax provision on its consolidated statements of comprehensive income. No significant interest or penalties were recognized during the periods presented.

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect the Company's business. Changes include, but are not limited to, a corporate tax rate decrease from 34% to 21% effective for tax years beginning after December 31, 2017, expensing of capital expenditures, the transition of U.S. international taxation from a worldwide tax system to a territorial system, a one-time transition tax on the mandatory deemed repatriation of cumulative foreign earnings, and limitations on the deductibility of certain executive compensation and other deductions. The Company is required to recognize the effect of the tax law changes in the period of enactment, including the transition

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(amounts in thousands, except share and per share amounts)

tax, re-measuring the Company's U.S. deferred tax assets and liabilities, as well as reassessing the net realizability of the Company's deferred tax assets and liabilities. During the fourth quarter of 2017, the Company recorded a provisional net charge of $7,578 related to the TCJA due to the remeasurement of the deferred taxes. The one-time transition tax on the mandatory deemed repatriation of foreign earnings was determined to be immaterial.

As of June 30, 2018, the Company has not completed the accounting for the income tax effects of the TCJA. No further changes have been made to the provisional amounts reported for the transition tax or the remeasurement of the deferred taxes during the six months ended June 30, 2018. For the foreign derived intangible income, executive compensation, and other deductions, the Company recorded an estimate in the effective tax rate for the six months ended June 30, 2018. The Company has not yet determined a policy election with respect to whether to record deferred taxes for basis differences expected to reverse as a result of the global intangible low tax income provisions in future periods or use the period cost method.

Given the significant complexity of the TCJA, the Company will continue to evaluate and analyze the impact of this legislation. New guidance from regulators, interpretation of the law, and refinement of the Company's estimates from ongoing analysis of data and tax positions may change the provisional amounts.

The Company has operations in the U.S., multiple U.S. states and the Netherlands. The statute of limitations has expired for all tax years prior to 2013 for federal jurisdictions and the Netherlands, and 2012 to 2013 for various state tax jurisdictions. However, the net operating loss generated on the Company's federal and state tax returns in prior years may be subject to adjustments by the federal and state tax authorities.

The Company determined the income tax provision for interim periods using an estimate of the Company's annual effective tax rate, adjusted for discrete items arising in that quarter. In each quarter, the Company updates its estimated annual effective tax rate, and if the estimated annual effective tax rate changes, a cumulative adjustment is recorded in that quarter. The Company's quarterly income tax provision and quarterly estimate of the annual effective tax rate are subject to volatility due to several factors, including our ability to accurately predict the proportion of our income (loss) before provision for income taxes in multiple jurisdictions, the tax effects of our stock-based compensation, and the effects of its acquisition and the integration of that acquisition.

7. Stockholders' equity

The Company has a 2002 Stock Incentive Plan (2002 Plan) as amended, under which the Company granted options to purchase shares of its common stock. As of June 30, 2018, options to purchase 18,949 shares of common stock remained outstanding under the 2002 Plan. The 2002 Plan was terminated in March 2012 in connection with the adoption of the 2012 Plan, and, accordingly, no new options are available for issuance under this plan. The 2002 Plan continues to govern outstanding awards granted thereunder.

The Company has a 2012 Equity Incentive Plan (2012 Plan) under which the Company granted options to purchase shares of its common stock. As of June 30, 2018, options to purchase 279,171 shares of common stock remained outstanding under the 2012 Plan. The 2012 Plan was terminated in connection with the Company's initial public offering in February 2014, and accordingly, no new options are available for issuance under this plan. The 2012 Plan continues to govern outstanding awards granted thereunder.

The Company has a 2014 Equity Incentive Plan (2014 Plan) that provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code, to the Company's employees and any parent and subsidiary corporation's employees, and for the grant of nonstatutory stock options, restricted stock, restricted stock units, restricted stock awards, stock appreciation rights, performance units and performance shares to its employees, directors and consultants and its parent and subsidiary corporations' employees and consultants.

As of June 30, 2018, awards with respect to 1,414,048 shares of the Company's common stock were outstanding, and 1,914,110 shares of common stock remained available for issuance under the 2014 Plan. The shares available for issuance under the 2014 Plan will be increased by any shares returned to the 2002 Plan, 2012 Plan and the 2014 Plan as a result of expiration or termination of awards (provided that the maximum number of shares that may be added to the 2014 Plan pursuant to such previously granted awards under the 2002 Plan and 2012 Plan is 2,328,569 shares). The number of shares available for issuance under the 2014 Plan also is increased annually on the first day of each fiscal year by an amount equal to the least of:

- 895,346 shares;

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Condensed Notes to the Consolidated Financial Statements (continued)

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(amounts in thousands, except share and per share amounts)

- 4% of the outstanding shares of common stock as of the last day of the Company's immediately preceding fiscal year; or
- such other amount as the Company's board of directors may determine.

For 2018, an additional 839,054 shares were added to the 2014 Plan share reserve pursuant to the provision described above.

Stock options

Options typically expire between seven and ten years from the date of grant and vest over one to four year terms. Options have been granted to employees, directors and consultants of the Company, as determined by the board of directors, at the deemed fair market value of the shares underlying the options at the date of grant.

The activity for stock options under the Company's stock plans is as follows:

	Options	Price per share	Weighted-average exercise price	Remaining weighted-average contractual terms (in years)	Per share average intrinsic value
Outstanding as of December 31, 2017	1,836,426	$0.60-$83.30	$ 30.77	4.58	$88.31
Granted	—	—	—		
Exercised	(276,016)	0.60-58.95	23.61		
Forfeited	(625)	24.52	24.52		
Expired	—	—	—		
Outstanding as of June 30, 2018	1,559,785	$0.60-$83.30	$ 32.04	4.24	$154.29
Vested and exercisable as of June 30, 2018	1,128,065	$0.60-$83.30	$ 27.97	4.12	$158.36
Vested and expected to vest as of June 30, 2018	1,531,385	$0.60-$83.30	$ 31.85	4.23	$154.48

The unrecognized compensation expense related to non-vested stock-based compensation granted under the Plans as of June 30, 2018 and June 30, 2017 was $6,419 and $13,285, respectively.

Stock incentive awards

The Company grants restricted stock units (RSUs) and restricted stock awards (RSAs) under the 2014 Plan (Stock Awards). The Stock Awards vest either based solely on the satisfaction of time-based service conditions or on the satisfaction of time-based service conditions combined with performance criteria. Stock Awards are subject to forfeiture if the holder’s services to the Company terminate before vesting.

Stock Awards granted with only time-based service vesting conditions generally vest over a four-year service period, as defined in the terms of each award. Stock Awards that vest based on the satisfaction of time-based service conditions combined with performance criteria generally vest over a three-year service and performance period, based on performance criteria established at the time of the grant of the award. The portion of the Stock Award that is earned may exceed, be equal to or be less than the targeted number of shares subject to the Stock Award depending on whether the performance criteria are met.

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Condensed Notes to the Consolidated Financial Statements (continued)

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(amounts in thousands, except share and per share amounts)

Stock Awards activity for the six months ended June 30, 2018, is summarized below:

	Time-based	Performance and time-based	Total	Weighted-average grant date fair value per share
Unvested restricted stock units outstanding as of December 31, 2017	42,028	13,109	55,137	$ 90.05
Granted	28,273	—	28,273	137.92
Vested	(2,295)	(4,370)	(6,665)	86.70
Forfeited/canceled	(1,452)	—	(1,452)	104.81
Unvested restricted stock units outstanding as of June 30, 2018 (1)	66,554	8,739	75,293	$ 108.04
Unvested and expected to vest restricted stock units outstanding as of June 30, 2018			69,947	$ 108.69
Unvested restricted stock awards outstanding as of December 31, 2017	20,789	20,785	41,574	$ 91.52
Granted	21,222	31,830	53,052	122.00
Vested	—	(6,928)	(6,928)	91.52
Forfeited/canceled	—	—	—	—
Unvested restricted stock awards outstanding as of June 30, 2018 (1)	42,011	45,687	87,698	$ 108.30
Unvested and expected to vest restricted stock awards outstanding as of June 30, 2018			69,176	$ 108.43

(1) Outstanding restricted stock units and restricted stock awards are based on the maximum payout of the targeted number of shares.

As of June 30, 2018, the unrecognized compensation cost related to unvested employee restricted stock units and restricted stock awards was $12,214, excluding estimated forfeitures. This amount is expected to be recognized over a weighted-average period of 2.8 years.

Employee stock purchase plan

The Company's 2014 Employee Stock Purchase Plan (ESPP) provides for the grant to all eligible employees an option to purchase stock under the ESPP, within the meaning Section 423 of the Internal Revenue Code. The ESPP permits participants to purchase common stock through payroll deductions of up to 15% of their eligible compensation, which includes a participant's base straight time gross earnings, incentive compensation, bonuses, overtime and shift premium, but exclusive of payments for equity compensation and other similar compensation. A participant may purchase a maximum of 1,500 shares during a purchase period. Amounts deducted and accumulated by the participant are used to purchase shares of the Company's common stock at the end of each six-month period. The purchase price of the shares will be 85% of the lower of the fair market value of the Company's common stock on the first trading day of each offering period or on the exercise date. The offering periods are currently approximately six months in length beginning on the first business day on or after March 1 and September 1 of each year and ending on the first business day on or after September 1 and March 1 approximately six months later.

As of June 30, 2018, a total of 759,967 shares of common stock were available for sale pursuant to the ESPP.

The number of shares available for sale under the ESPP is increased annually on the first day of each fiscal year by an amount equal to the least of:

- 179,069 shares;
- 1.5% of the outstanding shares of the Company's common stock on the last day of the Company's immediately preceding fiscal year; or
- such other amount as may be determined by the administrator.

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Condensed Notes to the Consolidated Financial Statements (continued)

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(amounts in thousands, except share and per share amounts)

For 2018, an additional 179,069 shares were added to the ESPP share reserve pursuant to the provision described above.

Stock-based compensation

Stock-based compensation expense recognized for the three months and six months ended June 30, 2018 and June 30, 2017 was as follows:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Stock-based compensation expense by type of award:				
Stock option plan awards	$1,548	$2,055	$3,500	$3,799
Restricted stock units and restricted stock awards	1,416	24	2,654	48
Employee stock purchase plan	222	137	413	260
Total stock-based compensation expense	$3,186	$2,216	$6,567	$4,107

Employee stock-based compensation expense was calculated based on awards of stock options, restricted stock units and restricted stock awards ultimately expected to vest based on the Company's historical award cancellations. The employee stock-based compensation expense recognized for the six months ended June 30, 2018 and June 30, 2017 has been reduced for estimated forfeitures of stock option plan awards at a rate of 7.3% and 7.3%, respectively. The employee stock-based compensation expense recognized for the six months ended June 30, 2018 and June 30, 2017 has been reduced for estimated forfeitures of restricted stock at a rate of 4.7% and 5.7%, respectively. ASC 718 – Compensation-Stock Compensation requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

For the three months and six months ended June 30, 2018 and June 30, 2017, stock-based compensation expense recognized under ASC 718, included in cost of revenue, research and development expense, sales and marketing expense, and general and administrative expense, was as follows:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Cost of revenue	$259	$212	$532	$403
Research and development	330	250	661	473
Sales and marketing	583	347	1,131	662

General and administrative	2,014	1,407	4,243	2,569
Total stock-based compensation expense	$3,186	$2,216	$6,567	$4,107

401(k) retirement savings plan

The Company maintains a 401(k) retirement savings plan for the benefit of eligible employees. Under the terms of this plan, eligible employees are able to make contributions to the plan on a tax-deferred basis. The Company began matching employees' contributions, effective January 1, 2017. The Company contributed $417, net of forfeitures, to the 401(k) plan for the six months ended June 30, 2018 and $293, net of forfeitures, for the six months ended June 30, 2017.

Inogen, Inc.

Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

8. Commitments and contingencies

Leases and non-cancelable contractual obligations

The Company leases its facilities and certain equipment under operating leases that expire through September 2024. As of June 30, 2018, the minimum aggregate payments due under operating leases and specified non-cancelable contractual obligations, which consist of software license and maintenance agreements, are summarized as follows:

	Operating leases	Related party leases	Non-cancelable contractual obligations	Total
Remaining 6 months of 2018	$ 999	$ 16	$ 289	$ 1,304
2019	2,437	31	578	3,046
2020	2,195	10	578	2,783
2021	1,580	—	456	2,036
2022	1,262	—	—	1,262
Thereafter	2,130	—	—	2,130
	$ 10,603	$ 57	$ 1,901	$ 12,561

As a result of the MedSupport acquisition, the Company leases a property owned by a related party. Rent expense for the property was $8 and $16 for the three and six months ended June 30, 2018.

Rent expense of $408 and $278 for the three months ended June 30, 2018 and June 30, 2017, respectively, and $729 and $540 for the six months ended June 30, 2018 and June 30, 2017, respectively, was included in the accompanying consolidated statements of comprehensive income.

Purchase obligations

The Company had approximately $60,400 of outstanding purchase orders with its outside vendors and suppliers as of June 30, 2018.

Warranty obligations

Accruals for estimated standard warranty expenses are made at the time that the associated revenue is recognized. The provisions for estimated warranty obligations are made based on known claims and estimates of additional returns and warranty obligations based on historical data and future expectations. The following table identifies the changes in the Company's aggregate product warranty liabilities for the six and twelve-month periods ended June 30, 2018 and December 31, 2017, respectively:

	June 30, 2018	December 31, 2017
Product warranty liability at beginning of period	$6,171	$ 3,480
Accruals for warranties issued	4,050	5,275
Adjustments related to preexisting warranties (including changes in estimates)	300	200
Settlements made (in cash or in kind)	(1,791)	(2,784)
Product warranty liability at end of period	$8,730	$ 6,171

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Condensed Notes to the Consolidated Financial Statements (continued)

(unaudited)

(amounts in thousands, except share and per share amounts)

Legislation and HIPAA

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in exclusion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

The Company believes that it is in compliance in all material respects with applicable fraud and abuse regulations and other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) ensures health insurance portability, reduces healthcare fraud and abuse, guarantees security and privacy of health information, and enforces standards for health information. The Health Information Technology for Economic and Clinical Health Act (HITECH Act) imposes notification requirements of certain security breaches relating to protected health information. The Company believes that it complies in all material respects with the provisions of those regulations that are applicable to the Company’s business.

Legal proceedings

The Company is party to various legal proceedings arising in the normal course of business. The Company carries insurance, subject to specified deductibles under the policies, to protect against losses from certain liabilities and costs. At this time, the Company does not anticipate that any of these other proceedings will have a material adverse effect on the Company’s business. Regardless of the outcome, litigation can have an adverse impact on the Company because of defense and settlement costs, diversion of management resources, and other factors.

9. Foreign currency exchange contracts and hedging

As of June 30, 2018 and June 30, 2017, the Company’s total non-designated and designated derivative contracts had notional amounts totaling approximately $3,072 and $12,477, respectively, and $2,529 and $8,644, respectively. These contracts were comprised of offsetting contracts with the same counterparty, each expires within one to six months, and had an unrealized gain of approximately $543, net of tax, during the six months ended June 30, 2018, and an unrealized loss of approximately $254, net of tax, during the six months ended June 30, 2017.

The nonperformance risk of the Company and the counterparty did not have a material impact on the fair value of the derivatives. During the six months ended June 30, 2018 and June 30, 2017, the ineffective portion relating to these hedges was immaterial and the hedges remained effective through their respective settlement dates. As of June 30, 2018, the Company had twenty-one designated hedges and four non-designated hedges. As of June 30, 2017, the Company had thirteen designated hedges and four non-designated hedges.

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

Forward-Looking Statements

The following discussion and analysis should be read together with our consolidated financial statements and the condensed notes to those statements included elsewhere in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, that are based on our management's beliefs and assumptions and on information currently available to our management. The forward-looking statements are contained principally in the section entitled "Risk Factors" and this Management's Discussion and Analysis of Financial Condition and Results of Operations. Forward-looking statements include, but are not limited to, statements concerning the following:

- information concerning our possible or assumed future cash flow, revenue, sources of revenue and results of operations, operating and other expenses;
- our assessment of reduced reimbursement rates, the continued impact from competitive bidding, future declines in rental revenue, and future decline in rental patients on service;
- our expectations regarding regulatory approvals and government and third-party payor coverage and reimbursement;
- our ability to develop new products, improve our existing products and increase the value of our products;
- our expectations regarding the timing of new products and product improvement launches;
- market share expectations, unit sales, business strategies, financing plans, expansion of our business, competitive position, industry environment, and potential growth opportunities;
- our expectations regarding the market size, market growth and the growth potential for our business;
- our ability to sustain and manage growth, including our ability to develop new products and enter new markets;
- our expectations regarding the average selling price and manufacturing costs of our products, including our expectations to continue to reduce average unit costs for our systems and the impact of the recent reduction in the retail price of our products;
- our expectation to expand our sales and marketing channels, including through hiring additional sales representatives, and expanding our advertising campaigns;
- our expectations with respect to our European and U.S. facilities and our expectations with respect to our contract manufacturer in Europe;
- our ability to successfully acquire and integrate companies and assets and the anticipated benefits from our acquisition of MedSupport Systems B.V. (MedSupport);
- our expectations regarding trade regulations and the impact of such trade regulations on our supply chain;
- our expectations regarding excess tax benefits from stock-based compensation;
- our expectations of future accounting pronouncements or changes in our accounting policies;
- our assessments and estimates of our effective tax rate;
- our internal control environment;
- the effects of seasonal trends on our results of operations and estimated hiring plans;
- our expectation that our existing capital resources and the cash to be generated from expected product sales and rentals will be sufficient to meet our projected operating and investing requirements for at least the next twelve months; and
- the effects of competition.

Forward-looking statements include statements that are not historical facts and can be identified by terms such as "anticipates," "believes," "could," "seeks," "estimates," "expects," "intends," "may," "plans," "potential," "predicts," "projects "would," or similar expressions and the negatives of those terms.

Forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance, or achievements to be materially different from any future results, performance, or

achievements expressed or implied by the forward-looking statements. We discuss these risks in greater detail in Part II, Item 1A, “Risk Factors,” elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or SEC. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Moreover, we operate in a

very competitive and rapidly changing environment. New risks emerge from time to time. It is not possible for us to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the future events and trends discussed in this Quarterly Report on Form 10-Q may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

Except as required by law, we assume no obligation to update these forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

This Quarterly Report on Form 10-Q also contains estimates, projections and other information concerning our industry, our business, and the markets for certain diseases, including data regarding the estimated size of those markets, and the incidence and prevalence of certain medical conditions. Information that is based on estimates, forecasts, projections, market research or similar methodologies is inherently subject to uncertainties and actual events or circumstances may differ materially from events and circumstances reflected in this information. Unless otherwise expressly stated, we obtained this industry, business, market and other data from reports, research surveys, studies and similar data prepared by market research firms and other third parties, industry, medical and general publications, government data and similar sources.

“Inogen,” “Inogen One,” “Inogen One G2,” “Inogen One G3,” “G4,” “Oxygenation,” “Live Life in Moments, not Minutes,” “N
Run Out of Oxygen,” “Oxygen Therapy on Your Terms,” “Oxygen.Anytime.Anywhere,” “Reclaim Your Independence,” “Intelligent Delivery Technology,” “Inogen At Home,” and the Inogen design are registered trademarks with the United States Patent and Trademark Office of Inogen, Inc. We own trademark registrations for the mark “Inogen” in Australia, Canada, South Korea, Mexico, Europe (European Union Registration), and Japan. We own a trademark registration for the mark “ ” in Japan. We own trademark registrations for the mark “Inogen One” in Australia, Canada, China, South Korea, Mexico, and Europe (European Union Registration). We own a trademark registration for the mark “Satellite Conserver” in Canada. We own a trademark registration for the mark “Inogen At Home” in Europe (European Union Registration). We own trademark registrations for the mark “G4” in Europe (European Union Registration) and the United Kingdom. Other service marks, trademarks, and trade names referred to in this Quarterly Report on Form 10-Q are the property of their respective owners.

In this Quarterly Report on Form 10-Q, “we,” “us” and “our” refer to Inogen, Inc. and its subsidiaries.

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and the accompanying condensed notes to those statements included elsewhere in this document. Also, forward-looking statements represent our management’s beliefs and assumptions only as of the date of this Quarterly Report on Form 10-Q.

Critical accounting policies and significant estimates

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

There have been no material changes in our critical accounting policies and estimates in the preparation of our consolidated financial statements during the three and six months ended June 30, 2018 compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018.

Overview

We are a medical technology company that primarily develops, manufactures and markets innovative portable oxygen concentrators used to deliver supplemental long-term oxygen therapy to patients suffering from chronic respiratory conditions. Traditionally, these patients have relied on stationary oxygen concentrator systems for use in the home and oxygen tanks or cylinders for mobile use, which we call the delivery model. The tanks and cylinders must be delivered regularly and have a finite amount of oxygen, which requires patients to plan activities outside of their homes around delivery schedules and a finite oxygen supply. Additionally, patients must attach long, cumbersome tubing to their stationary concentrators simply to enable mobility within their homes. Our proprietary Inogen One® systems concentrate the air around the patient to offer a single source of supplemental oxygen anytime, anywhere with a portable device weighing approximately 2.8 or 4.8 pounds with a single battery. We believe our Inogen One systems reduce the patient’s reliance on stationary concentrators and scheduled deliveries of tanks with a finite supply of oxygen, thereby improving patient quality of life and fostering mobility.

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

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

- Expand our domestic sales and marketing channels. During the year ended December 31, 2017, we increased our inside sales representatives to 263 from 177 as of December 31, 2016 in support of our direct-to-consumer domestic sales. Typically, we expect new inside sales representatives to take 4 to 6 months to reach full productivity. We are also focused on building our domestic business-to-business partnerships, including relationships with distributors, key accounts, resellers, our private label partner, and traditional home medical equipment (HME) providers.
- Invest in our product offerings to develop innovative products. We expended $1.8 million and $1.3 million for the three months ended June 30, 2018 and June 30, 2017, respectively, and $3.2 million and $2.6 million for the six months ended June 30, 2018 and June 30, 2017, respectively, in research and development expenses, and we intend to continue to make such investments in the foreseeable future. We launched our fourth-generation portable oxygen concentrator, the Inogen One G4, in May 2016. The Inogen One G4 weighs 2.8 pounds, versus 4.8 pounds for our Inogen One G3, and is approximately half the size of the Inogen One G3. The sound level is 40 dBA at setting 2 and it produces up to 630 ml/minute of oxygen output. We estimate that it is suitable for more than 85% of supplemental long-term ambulatory oxygen therapy patients who contact us. The Inogen One G4 system is also less expensive to manufacture than our Inogen One G3 system. We also launched an upgraded battery option for the Inogen One G3 system to increase battery life by approximately 10% in the fourth quarter of 2016. We are also developing our next-generation portable oxygen concentrator (POC), the Inogen One G5 and developing connectivity capabilities for our products.
- Increase international business-to-business adoption. Although our main growth opportunity remains POC adoption in the United States given the relatively low penetration rate, we are keenly aware of the large international market opportunity. In order to take advantage of these international opportunities, we have started to build out an infrastructure over the last few years, which includes sales in 46 international countries and a contract manufacturing partner to support European sales volumes. Further, we are also in the process of developing regulatory and sales pathways to capture opportunities in new and emerging markets. Over time, as the U.S. and European markets mature, our growth will depend on our ability to drive POC adoption in emerging markets, where limited oxygen therapy treatment exists today. In the second quarter of 2018, we received reimbursement approval of the Inogen One G4 product in France.

We have been developing and refining the manufacturing of our Inogen One systems since 2004. While nearly all of our manufacturing and assembly processes were originally outsourced, assembly of the compressors, sieve beds, concentrators and certain manifolds were brought in-house in order to improve quality control and reduce cost. In support of our European sales, we established a physical presence in Europe by acquiring our former distributor, MedSupport Systems B.V. (MedSupport) on May 4, 2017 and began production of our Inogen One G3 concentrators in the fourth quarter of 2017 using a contract manufacturer, Foxconn, located in the Czech Republic to improve our ability to service our European customers. Our contract manufacturer produces the vast majority of the Inogen One G3 concentrators required to support our European demand. We expect to maintain our assembly operations for our Inogen One concentrators and Inogen At Home concentrators at our facilities in Richardson, Texas and Goleta, California. This has allowed us to continue to expand our manufacturing capacity and redirect our U.S. manufacturing activities to focus on growth in the U.S. and on our latest product, the Inogen One G4.

We also use lean manufacturing practices to maximize manufacturing efficiency. We rely on third-party manufacturers to supply several components of our Inogen One and Inogen At Home systems. We typically enter into supply agreements for these components that specify quantity and quality requirements and delivery terms. In certain cases, these agreements can be terminated by either party upon relatively short notice. We have elected to source certain key components from single sources of supply, including our batteries, motors, valves, and some molded plastic components. We believe that maintaining a single source of supply allows us to control production costs and inventory levels and to manage component quality. However, any reduction or halt in supply from one of these single-source suppliers could limit our ability to manufacture our products or devices until a replacement supplier is found and qualified.

Historically, we have generated a majority of our revenue from sales and rentals to customers in the United States. For the three months ended June 30, 2018 and June 30, 2017, approximately 21.3% and 23.3%, respectively, and 21.4% and 22.6% for the six months ended June 30, 2018 and June 30, 2017, respectively, of our total revenue was from sales to customers outside the United States, primarily in Europe. Approximately 76.0% and 75.4% of the non-U.S. revenue for the three months ended June 30, 2018 and June 30, 2017, respectively, and 76.4% and 73.9% for the six months ended June 30, 2018 and June 30, 2017, respectively, was invoiced in Euros with the remainder invoiced in United States dollars. As of June 30, 2018, we sold our products in 46 countries outside the United States through our wholly owned subsidiary, distributors or directly to large “house” accounts, which include gas companies, HME oxygen providers, and resellers. In those instances, we sell to and bill the distributor or “house” accounts directly, leaving responsibility for the patient billing, support and clinical setup to the local provider.

Our total revenue was $97.2 million and $64.1 million for the three months ended June 30, 2018 and June 30, 2017, respectively, and $176.3 million and $116.6 million for the six months ended June 30, 2018 and June 30, 2017, respectively. The increase was primarily due to growth in sales revenue associated with the increases in direct-to-consumer and business-to-business sales of our Inogen One systems, partially offset by a decline in rental revenue primarily associated with a decline in patients on service. We generated net income of $14.6 million and $8.3 million for the three months ended June 30, 2018 and June 30, 2017, respectively, and $25.4 million and $14.3 million for the six months ended June 30, 2018 and June 30, 2017, respectively. We generated Adjusted EBITDA of $19.0 million and $14.4 million for the three months ended June 30, 2018 and June 30, 2017, respectively, and $34.5 million and $25.2 million for the six months ended June 30, 2018 and June 30, 2017, respectively (see “Non-GAAP financial measures” for reconciliations between U.S. GAAP and non-GAAP results). As of June 30, 2018, our retained earnings were $34.0 million.

Sales revenue

Our future financial performance will be driven in part by the growth in sales of our Inogen One systems, and, to a lesser extent, sales of batteries, other accessories, and sales of our Inogen At Home stationary oxygen concentrators. We plan to grow our system sales in the coming years through multiple strategies including: expanding our direct-to-consumer sales efforts through hiring additional sales representatives, investing in consumer awareness through increased marketing efforts, expanding our sales infrastructure and efforts outside of the United States, expanding our business-to-business sales through key partnerships, and enhancing our product offerings through additional product launches. As our product offerings grow, we solicit feedback from our customers and focus our research and development efforts on continuing to improve patient preference and reduce the total cost of the product in order to further drive sales of our products. For example, in the second quarter of 2018, we completed a direct-to-consumer pricing elasticity trial which indicated that by lowering our price we can expand access to our products and increase sales volumes while also improving our total gross margin profile. Accordingly, as of June 1, 2018, we reduced the starting retail minimum advertised price for our Inogen One G3 and Inogen One G4 systems.

Our direct-to-consumer sales process involves numerous interactions with the individual patient, the physician and the physician's staff, and includes an in-depth analysis and review of our product, the patient's diagnosis and prescribed oxygen therapy, including procuring an oxygen prescription. The patient may consider whether to finance the product through an Inogen-approved third-party or purchase the equipment. Product is not deployed until both the prescription and payment are received. Once product is deployed, the patient has 30 calendar days to return the product, subject to the payment of a minimal processing and handling fee. Approximately 7-14% of consumers who purchase a system return the system during this 30-day return period.

Our business-to-business efforts are focused on selling to distributors, HME oxygen providers, our private label partner and resellers, who are based inside and outside of the United States. This process involves interactions with various key customer stakeholders including sales, purchasing, product testing, and clinical personnel. Businesses that have patient demand that can be met with our oxygen concentrator systems place purchase orders to secure product deployment. This may be influenced based on outside factors, including the result of tender offerings, changes in insurance plan coverage, and overall changes in the net oxygen therapy patient population. Products are shipped freight on board (FOB) Inogen dock domestically, and based on financial history and profile, businesses may either prepay or receive extended payment terms. Products are shipped both FOB Inogen dock and Delivery Duty Paid (DDP) for certain international shipments depending on the shipper used. DDP shipments are Inogen's property until title has transferred which is upon duty being paid and delivered to the customer. As a result of these factors, product purchases can be subject to changes in demand by customers.

We sold approximately 54,700 systems in the three months ended June 30, 2018 compared to 32,400 systems for the same period in 2017. We sold approximately 100,100 systems in the six months ended June 30, 2018 compared to 58,000 systems for the same period in 2017. Management focuses on system sales as an indicator of current business success.

Rental revenue

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

We expect rental revenue to be down approximately 10% in 2018 as compared to 2017, primarily due to our continued focus on sales versus rentals. We plan to add new rental patients on service in future periods through multiple strategies, including expanding our direct-to-consumer marketing efforts through hiring additional sales representatives, investing in patient and physician awareness, and securing additional insurance contracts. However, patients may come off our services due to death, a change in their condition, a change in location, a change in healthcare provider or other factors. In each case, we maintain asset ownership and can redeploy assets as appropriate following such events. Given the length and uncertainty of our patient acquisition cycle and potential returns we have experienced in the past, and likely will experience in the future, fluctuations in our net new patient setups will occur on a period-to-period basis and we may experience negative net patient additions in future periods. At this time, we do not plan to offer our Inogen One G4 system to rental patients but will continue to use the Inogen One G3 system as the primary ambulatory solution deployed in our rental fleet.

A portion of rentals include a capped rental period during which no additional reimbursement is allowed unless additional criteria are met. In this scenario, the ratio of billable patients to total patients on service is critical to maintaining rental revenue growth as patients on service increases. Medicare has noted a certain percentage of beneficiaries, approximately 25%, based on their review of Medicare claims, reach the 36th month of eligible reimbursement and enter the capped rental period. Our capped patients as a percentage of total patients on service was approximately 17.7% as of June 30, 2018 compared to approximately 17.9% as of June 30, 2017. The percentage of capped patients may fluctuate over time as new patients come on service, patients come off of service before and during the capped rental period, and existing patients enter the capped rental period.

As of June 30, 2018, we had approximately 28,500 oxygen rental patients, a decrease from approximately 32,300 oxygen rental patients as of June 30, 2017. Management focuses on patients on service as a leading indicator of likely future rental revenue; however, actual rental revenue recognized is subject to a variety of other factors, including reimbursement levels by payor, patient location, the number of capped patients, write-offs for uncollectable balances, and adjustments for patients in transition.

Reimbursement

We rely heavily on reimbursement from the Centers for Medicare and Medicaid Services (CMS), and secondarily, from private payors, Medicaid and patients for our rental revenue.

For the three months and six months ended June 30, 2018, approximately 76.5% and 75.8% of our rental revenue was derived from Medicare's service reimbursement programs. The U.S. list price for our stationary oxygen rentals (HCPCS E1390) is $260 per month and the U.S. list price for our oxygen generating portable equipment (OGPE) rentals (HCPCS E1392) is $70 per month. Effective January 1, 2016, the current standard Medicare allowable varies by state instead of the one national standard allowable as in previous years. Effective January 1, 2016, the Medicare allowable for stationary oxygen rentals (E1390) ranges from $135.14 to $145.61 per month and the OGPE rentals (E1392) ranges from $46.69 to $49.52 per month. Effective January 1, 2017, the Medicare allowable for stationary oxygen rentals (E1390) ranges from $66.53 to $77.16 per month and the OGPE rentals (E1392) ranges from $36.14 to $41.91 per month. These are the two primary codes that we bill to Medicare and other payors for our oxygen product rentals.

As of January 1, 2011, Medicare phased in the competitive bidding program. The competitive bidding program impacts the amount Medicare reimburses suppliers of durable medical equipment rentals, including portable oxygen concentrators. The program is defined geographically, with suppliers submitting bids to provide medical equipment for specific product categories within a specified geographic region called competitive bidding areas, or CBAs. Once bids have been placed, an individual company's bids within a product category are aggregated and weighted by each product's market share in the category. The weighted-average price is then indexed against all bidding suppliers. Medicare determines a "clearing price" out of these weighted-average prices, at which a

sufficient number of suppliers have indicated they will support patients in the category. This threshold is typically designed to generate theoretical supply that is twice the expected demand. Bids for each modality among the suppliers that made the cut are then arrayed to determine what Medicare will reimburse for each product category and geographic area. The program has strict anti-collusion guidelines to ensure bidding is truly competitive. A competitive bidding contract lasts up to three years once implemented, after which the contract can be subject to a new round of bidding. Discounts off the standard Medicare allowable occur in CBAs where contracts have been awarded as well as in cases where private payors pay less than this allowable. Competitive bidding rates are based on the zip code where the patient resides. Rental revenue includes payments for product, disposables, and customer service/support.

In the CBAs covered under round two re-compete of the competitive bidding program, which began July 1, 2016, the Medicare allowable for stationary oxygen rentals (E1390) ranges from $70.00 to $89.86 per month (average of $76.84 per month) and the OGPE rentals (E1392) ranges from $33.97 to $42.00 per month (average of $37.90 per month). In the CBAs covered under round one 2017 of the competitive bidding program, which began January 1, 2017, the Medicare allowable for stationary oxygen rentals (E1390) ranges from $70.04 to $90.01 per month (average of $77.97 per month) and the OGPE rentals (E1392) ranges from $35.11 to $37.15 per month (average of $36.06 per month).

As of January 1, 2016, all areas previously not subject to competitive bidding program (non-competitive bidding areas or “non-CBAs”) have experienced reductions in the Medicare fee schedule for durable medical equipment, prosthetics, orthotics and supplies (DMEPOS). The fee schedules in the non-CBAs were adjusted based on regional averages of the single payment amounts that apply to the competitive bidding program (Adjusted Fee Schedule). The regional prices are limited by a national ceiling (110% of the average of the regional prices) and a national floor (90% of the average regional prices). From January 1, 2016 to June 30, 2016, the reimbursement rates for these non-CBAs (with dates of service from January 1, 2016 to June 30, 2016) were 50% of the un-adjusted fee schedule amount plus 50% of the Adjusted Fee schedule amount. As of July 1, 2016, Medicare reimbursed DMEPOS at 100% of the Adjusted Fee Schedule amount. However, in December 2016, the 21st Century Cures Act (“Cures Act”) was passed, which included a provision to roll-back the second cut to the non-CBA areas that was effective July 1, 2016 through December 31, 2016. Pricing in these areas was increased to the rates experienced in the period from January 1, 2016 through June 30, 2016. This led to a benefit in rental revenue of $2.0 million in the fourth quarter of 2016 and $0.2 million in the first quarter of 2017. Effective January 1, 2017, rates are set at 100% of the Adjusted Fee Schedule amount, based on the regional competitive bidding rates. The Cures Act also called for a study of the impact of the competitive bidding pricing on rural areas and accelerated the implementation of the Omnibus bill passed in December 2015 to require state Medicaid agencies to match Medicare fee schedule reimbursement rates (including single payment amounts in applicable areas), effective as of January 1, 2018, including for oxygen.

The competitive bidding regions are defined as follows:

Region Name	States Covered
Far West	CA, NV, OR, WA
Great Lakes	IL, IN, MI, OH, WI
Mideast	DC, DE, MD, NJ, NY, PA
New England	CT, MA, NH, RI
Plains	IA, KS, MN, MO, NE
Rocky Mountain	CO, ID, UT
Southeast	AL, AR, FL, GA, KY, LA, NC, SC, TN, VA
Southwest	AZ, NM, OK, TX

In addition to regional pricing, CMS imposed different pricing on “frontier states” and rural areas. CMS defines frontier states as states where more than 50% of the counties in the state have a population density of 6 people or less per

square mile and rural states are defined as states where more than 50% of the population lives in rural areas per census data. Current frontier states include MT, ND, SD and WY; rural states include ME, MS, VT and WV; and non-contiguous United States areas include AK, HI, Guam and Puerto Rico. For frontier and rural states, and frontier and rural zip codes in non-frontier/rural states, the single payment amount will be the national ceiling (110% of the average of the regional prices) to account for higher servicing costs in these areas. For non-contiguous United States areas, single payment amounts will be the higher of the national ceiling, or the average of competitive bidding pricing from these areas, if the areas had been bid through competitive bidding. We estimate that less than 10% of our patients would be eligible to receive the 110% of the regional prices for rural and frontier areas based on the geographic locations of our current patient population.

CMS has also re-bid for competitive bidding round two re-compete, which is associated with approximately 50% of the Medicare market, with contracts which began on July 1, 2016 and will continue through December 31, 2018. CMS updated the product categories and the competitive bidding areas in the round two re-compete contracts. Respiratory equipment now includes oxygen, oxygen equipment, continuous positive airway pressure devices, respiratory assist devices and related supplies and accessories. Nebulizers are now their own separate product category instead of being included in the respiratory equipment category.

Round two re-compete is in the same geographic areas that were included in the original round two. However, as a result of the Office of Management and Budget's updates to the original 91 round two metropolitan statistical areas, there are now 90 metropolitan statistical areas for round two re-compete and 117 competitive bidding areas (CBAs). Any CBA that was previously located in multi-state metropolitan statistical areas was redefined so that no CBA is included in more than one state. The round two re-compete competitive bidding areas have nearly the same zip codes as the round two competitive bidding areas; the associated changes in the zip codes since competitive bidding was implemented are reflective in this round two re-compete.

CMS has also re-bid for the round one 2017 contracts effective January 1, 2017 through December 31, 2018. In round one 2017, there are 9 metropolitan statistical areas and 13 CBAs to ensure there are no multi-state CBAs. We estimate approximately 9% of the Medicare market was impacted by the round one 2017 contracts.

The following table sets forth the current Medicare standard allowable reimbursement rates and the average of reimbursement rates applicable in Metropolitan Statistical Areas covered by rounds one and two of competitive bidding.

	Round two average 7/1/13-6/30/16	Round one re-compete average 1/1/14-12/31/16	Round two re-compete average 7/1/16-12/31/18	Round one 2017 average 1/1/17-12/31/18
E1390 (stationary oxygen rentals)	$93.07	$ 95.74	$ 76.84	$77.97
E1392 (portable oxygen rentals)	42.72	38.08	37.90	36.06
Total	$135.79	$ 133.82	$ 114.74	$114.03

In addition to reducing the Medicare reimbursement rates in the Metropolitan Statistical Areas (MSAs), the competitive bidding program has effectively reduced the number of oxygen suppliers that can participate in the Medicare program. Based on industry data analyzing the number of unique supplier companies by state from July 2013 to April 2017, there has been a 41% decrease in the numbers of DMEPOS suppliers who have an active NPI number. We believe that approximately 59% of the Medicare market was covered by round one and round two of competitive bidding.

Cumulatively in round one, round two, round one re-compete, round two re-compete and round one 2017, we were offered contracts for a substantial majority of the CBAs and product categories for which we submitted bids. However, there is no guarantee that we will garner additional market share as a result of these contracts. The contracts include products that may require us to subcontract certain services or products to third parties, which must be approved by CMS. As of July 2018, we currently operate in all 50 states in the U.S. We did not sell or rent to patients in Hawaii due to the licensure requirements from inception to June 2018.

Moreover, we cannot guarantee that we will be offered contracts in subsequent rounds of competitive bidding. In all five rounds of competitive bidding in which we have participated, we have gained access to certain CBAs and been excluded from other CBAs.

Following round one of competitive bidding, we were excluded from providing services to Medicare beneficiaries in the Kansas City-MO-KS, Miami-Fort Lauderdale-Pompano Beach-FL, and Orlando-Kissimmee-FL CBAs. We had access to six CBAs of the nine regions subject to competitive bidding round one for the respiratory product category.

After round one re-compete of competitive bidding, we were excluded from providing services to Medicare beneficiaries in the following CBAs: Cleveland-Elyria-Mentor-OH, Cincinnati-Middleton-OH-KY-IN, Miami-Fort Lauderdale-Pompano Beach-FL, Orlando-Kissimmee-Sanford-FL, Pittsburg-PA, and Riverside-San Bernardino-Ontario-CA. We gained access to the Kansas City-MO -KS CBA. We had access to three CBAs of the nine regions subject to competitive bidding round one re-compete for the respiratory product category.

After round one 2017 of competitive bidding, we have been excluded from the Chester-Lancaster and York Counties-SC CBA, which we previously won under round one re-compete. We also have been excluded from the Miami-Fort Lauderdale-West Palm Beach-FL and Orlando-Kissimmee-Sanford-FL CBAs. We have access to 10 of the 13 CBAs in which we bid for the respiratory product category: Charlotte-Concord-Gastonia-NC, Cincinnati-OH, Cleveland-Elyria-OH, Covington-Florence-Newport-KY, Dallas-Fort Worth-Arlington-TX, Dearborn-Franklin-Ohio, and Union Counties-IN, Kansas City-MO, Kansas City-Overland Park-Ottawa-KS, Pittsburgh-PA, and Riverside-San Bernardino-Ontario-CA. We have access to ten CBAs of the thirteen regions subject to competitive bidding round one 2017 for the respiratory product category.

After round two of competitive bidding, we were excluded from 12 CBAs: Akron-OH, Cape Coral-Fort Myers-FL, Deltona-Daytona Beach-Ormond Beach-FL, Honolulu-HI, Jacksonville-FL, Lakeland-Winter Haven-FL, Memphis-TN-MS-AR, North Port-Bradenton-Sarasota-FL, Ocala-FL, Palm Bay-Melbourne-Titusville-FL, Tampa-St. Petersburg-Clearwater-FL, and Toledo-OH. We had access to 88 CBAs of the 100 regions subject to competitive bidding round two for the respiratory product category.

After round two re-compete of competitive bidding, we were excluded from the following CBAs that we had previously won under round two: Allentown-Bethlehem-Easton-PA, Asheville-NC, Augusta-Richmond County-GA, Camden-NJ, Catoosa-Dade-Walker Counties-GA, Elizabeth-Lakewood-New Brunswick-NJ, Flint-MI, Greensboro-High Point-NC, Greenville-Anderson-Mauldin-SC, Jersey City-Newark-NJ, Las Vegas-Henderson-Paradise-NV, Little Rock-North Little Rock-Conway-AR, Louisville-Jefferson County-KY, Mercer County-PA, Poughkeepsie-Newburgh-Middletown-NY, Raleigh-NC, Scranton-Wilkes-Barre-Hazelton-PA, Stockton-Lodi-CA, Syracuse-NY, Wilmington-DE, and Youngstown-Warren-Boardman-OH. We were also excluded from the following CBAs in both round two and round two re-compete: Akron-OH and Toledo-OH. We gained access to certain Medicare markets in Cape-Coral-Fort Myers-FL, Deltona-Daytona Beach-Ormond Beach-FL, Jacksonville-FL, Lakeland-Winter Haven-FL, North Port-Sarasota-Bradenton-FL, Ocala-FL, Palm Bay-Melbourne-Titusville-FL, and Tampa-St. Petersburg-Clearwater-FL. We have access to 93 CBAs of the 117 regions subject to competitive bidding round two re-compete for the respiratory product category.

Effective January 1, 2017, we believe we have access to over 85% of the Medicare oxygen therapy market based on our analysis of the 103 CBAs that we have won out of the 130 total CBAs. These 130 CBAs represent approximately 59% of the market with the remaining approximately 41% of the market not subject to competitive bidding. The loss of access to the CBAs where we were not awarded contracts is not expected to lead to a material adverse impact on our rental business. Medicare revenue, including patient co-insurance and deductible obligations, represented 4.1% of our total revenue in the three months ended June 30, 2018 and 4.6% of our total revenue in the six months ended June 30, 2018. The decline in total revenue resulting from the loss of competitive bidding contracts in the areas that we were excluded from was partially offset by the “grandfathering” of existing Medicare patients (discussed below), rentals to patients with third-party insurance coverage, or Medicare patients paying out-of-pocket to purchase our products. Our revenue from Medicare in the 27 CBAs where we were not offered contracts as of January 1, 2017 was approximately $0.1 million and $0.2 million in the three months ended June 30, 2018 and June 30, 2017, respectively, and $0.3 million and $0.5 million in the six months ended June 30, 2018 and June 30, 2017, respectively.

Under the competitive bidding program, DME suppliers that are not awarded a competitive bid contract in a CBA and product category which the DME supplier had previously been awarded a competitive bid contract may “grandfather” existing patients on service beginning on the effective date of the competitive bidding round. This means DME suppliers may retain all existing patients and continue to receive reimbursement for them, so long as the new reimbursement rate is accepted by the DME supplier and the beneficiary chooses to continue to receive equipment from the supplier. For example, a supplier that received a round two contract but not a round two re-compete contract may elect to “grandfather’ the patients that it serviced through the round two contract period. Suppliers must either keep or release all patients under this “grandfathering” arrangement in each CBA; a supplier may not select specific individuals to retain or release. Suppliers can continue to sell equipment in CBAs where they were not awarded contracts to patients paying out-of-pocket or with third-party insurance coverage.

We have elected to “grandfather” and retain all patients in CBAs in which we were not awarded contracts. In addition, we continue to accept patients in CBAs where we did not receive contracts through private insurance. We also pursue retail sales of our equipment to patients in those areas.

Medicare reimbursement for oxygen rental equipment is limited to a maximum of 36 months within a 60-month service period, and the equipment remains the property of the home oxygen supplier. The supplier that billed

Medicare for the 36th month of service continues to be responsible for the patient's oxygen therapy needs for months 37 through 60, and there is generally no additional reimbursement for oxygen generating portable equipment for these later months. CMS does not separately reimburse suppliers for oxygen tubing, cannulas and supplies that may be required for the patient. The supplier is required to keep the equipment provided in working order and in some cases, CMS will reimburse for repair costs. At the end of the five-year useful life of the equipment, the patient may request replacement equipment and, if he or she can be re-qualified for the Medicare benefit, a new maximum 36-month payment cycle out of the next 60 months of service would begin. The supplier may not arbitrarily issue new equipment. We have analyzed the potential impact to revenue associated with patients in the capped rental period and have deferred $0 associated with the capped rental period for the three months and six months ended June 30, 2018 and June 30, 2017, respectively.

Our obligations to service Medicare patients over the contract rental period include supplying working equipment that meets each patient's oxygen needs pursuant to his/her doctor's prescription and certificate of medical necessity form and supplying all disposables required for the patient to operate the equipment, including cannulas, filters, replacement batteries, carts and carry bags, as needed. If the equipment malfunctions, we must repair or replace the equipment. We determine what equipment the patient receives, as long as that equipment meets the physician's prescription, and we can deploy used assets in working order as long as the prescription requirements are met. We must also procure a recertification of the certificate of medical necessity from the patient's

doctor to confirm the patient's need for oxygen therapy one year after the patient first receives oxygen therapy and one year after each new 36-month reimbursement period begins. The patient can choose to receive oxygen supplies and services from another supplier at any time, but the supplier may only transition the patient to another supplier in certain circumstances.

In addition to the adoption of the competitive bidding program, from 2010 through 2015, Medicare reimbursement rates for oxygen rental services in non-CBAs were eligible to receive mandatory annual updates based upon the Consumer Price Index for all Urban Consumers, or CPI-U. For 2014, the CPI-U was +1.8%, but the multi-factor productivity adjustment (Adjustment) was -0.8%, so the net result was a 1.0% increase in fee schedule payments in 2014 for items and services provided in areas not subject to competitive bidding. However, by law, the stationary oxygen equipment codes payment amounts must be adjusted on an annual basis, as necessary, to ensure budget neutrality of the new payment class for oxygen generating portable equipment (OGPE). Thus, the increase in allowable payment amounts for stationary oxygen equipment codes increased 0.5% from 2013 to 2014. For 2015, the CPI-U was +2.1%, but the Adjustment was -0.6%, so the net result was a 1.5% increase in fee schedule payments in 2015 for stationary oxygen equipment for items and services not included in an area subject to competitive bidding. Beginning in 2016, the standard allowable for all areas was set based on regional averages of the competitive bidding prices as described previously and no fees were based on non-competitive bidding. Accordingly, we do not anticipate future adjustments to the reimbursable fees based upon changes in CPI-U. However, as of January 1, 2017 and January 1, 2018 the Medicare reimbursement rates in the non-CBAs were adjusted to ensure budget neutrality based on the increased usage of the OGPE class that led to lower rates in these areas. Effective January 1, 2018, Medicare rates for stationary oxygen (code E1390) declined by 1.2% in non-CBA areas.

On November 4, 2016, CMS published a final rule in the Federal Register imposing additional regulations on the competitive bidding process. The final rule requires bidders choosing to participate in the competitive bidding program to obtain a $0.05 million surety bond for each CBA in which they bid. If a bidder does not accept a contract offer when its composite bid is at or below the median composite bid rate for suppliers used in the calculation of the single payment amount, the bid surety bond for the applicable CBA will be forfeited to CMS. In instances where the bidder does not meet the forfeiture conditions specified in the final rule, the bid surety bond liability will be returned to the bidder within 90 days of the public announcement of the contract suppliers for the CBA. Currently, there are 130 CBAs, which would mean a bidding supplier could incur a surety bond obligation with forfeiture conditions of up to $6.5 million. The final rule also changes the bid limits for individual items for future rounds of competitive bidding to reflect the 2015 unadjusted fee schedule to avoid a downward trend in bid pricing, to ensure the long-term viability of the competitive bidding program, and to allow suppliers to take into account both decreases and increases in costs in determining their bids. The rule also finalizes an appeals process for all breach of contract actions that CMS may take under the competitive bidding program. Lastly, the final rule sets forth a provision for lead item bidding for certain product categories in future bidding rounds to prevent the creation of price inversions, which occurred in round two of competitive bidding. Lead item bidding means that all HCPCS codes for similar items will be grouped together and priced relative to the bid for the "lead item," as calculated by CMS.

On November 2, 2017, a bi-partisan bill was introduced in the House of Representatives that would provide relief from competitive bidding in non-bid areas. This bill has 154 co-sponsors as of June 30, 2018. If passed, the bill would extend a retroactive delay of a second round of reimbursement cuts for Medicare beneficiaries from January 1, 2017 to January 1, 2019 based on the reimbursement rates effective on January 1, 2016. The legislation also proposes to remedy a double-dip cut to oxygen payments caused by the misapplication of a 2006 budget neutrality offset balancing increased utilization for oxygen generating portable equipment with lower reimbursement for stationary equipment.

On February 12, 2018, the current presidential administration sent Congress a 2019 budget proposal that included language on competitive bidding. Specifically, the proposal would eliminate the requirement under the competitive

bidding program that CMS pay a single payment amount based on the median bid price, proposing instead that CMS pay winning suppliers at their own bid amounts. Additionally, this proposal would expand competitive bidding to all areas of the country, including rural areas, which will be based on competition in those areas rather than on competition in urban areas. This specific proposal is estimated to save the government $6.5 billion over 10 years. In addition to changes to competitive bidding, the 2019 budget proposal would enable CMS not to impose the face-to-face requirement on all providers for durable medical equipment. Furthermore, the proposal seeks to address excessive billing of durable medical equipment that requires refills or serial claims. Specifically, Medicare would gain authority to test whether using a benefits manager for serial durable medical equipment claims would result in lower improper payments and reductions in inappropriate utilization. The benefits manager would be responsible for ensuring beneficiaries were receiving the correct quantity of supplies or service for the appropriate time period. Lastly, the proposal would expand prior authorization to additional items and services that are both high-cost and at high-risk for improper payments. These provisions were not included in the latest omnibus budget, so it is unclear if any of these proposals will be implemented. We believe additional cuts to reimbursement would continue to drive conversion to non-delivery technologies, including POCs.

On May 9, 2018, CMS released an Interim Final Rule to resume the 50/50 blended rate schedule for the period of June 1, 2018 through December 31, 2018 in rural and non-contiguous areas not subject to the competitive bidding program. We estimate that this will increase rental revenue by approximately $0.5 million in 2018.

On July 11, 2018, CMS released a new proposal to change the payment rules for Durable Medical Equipment Prosthetics, Orthotics, and Supplies (DMEPOS), including our portable oxygen concentrators. This includes a proposal that when the current competitive bidding contracts expire December 31, 2018, beneficiaries can obtain DMEPOS items from any enrolled Medicare supplier. In addition if this proposal is approved, the next competitive bidding round, which is expected to be delayed 18 to 24 months, will include multiple provisions to improve the program including: implementing lead item pricing, revising the definition of composite bid to mean the bid submitted by the supplier for the lead item in the product category, establishing a new method for single payment amounts based on maximum winning bids instead of median bids and establishing new separate payment classes for portable gaseous, portable liquid, and high flow portable liquid categories. In addition, CMS proposes to establish a new methodology for ensuring that all new classes for oxygen and equipment are budget neutral. Lastly, this proposal includes three different fee schedule adjustment methodologies depending on the area in which items and services are furnished: (1) one fee schedule adjustment methodology for DMEPOS items and services furnished on/after January 1, 2019 in areas currently in CBAs, in the event of a gap in competitive bidding; (2) another fee schedule adjustment methodology for items and services furnished from January 1, 2019 through December 31, 2020, in areas that are currently not CBAs, are not rural areas, and are located in the contiguous United States; and (3) another fee schedule adjustment methodology for items and services furnished from January 1, 2019 through December 31, 2020, in areas that are currently not CBAs and are either rural areas or non-contiguous areas. Comments on this proposed rule will be allowed through September 10, 2018.

As of June 30, 2018, we had 91 contracts with Medicaid and private payors. These contracts qualify us as an in-network provider for these payors. As a result, patients can rent or purchase our systems at the same patient obligation as other in-network oxygen suppliers. Based on our patient population, we believe at least 30% of all oxygen therapy patients are covered by private payors. Private payors typically provide reimbursement at a rate between 60% and 100% of Medicare allowables for in-network plans, and although private payor plans can have 36-month capped rental periods similar to Medicare, they typically do not. We anticipate that private payor reimbursement levels will generally be reset in accordance with Medicare payment amounts established through competitive bidding.

We cannot predict the full extent to which reimbursement for our products will be affected by competitive bidding, the 2019 federal budget or future federal budgets, or by initiatives to reduce costs for private payors. We believe that we are well positioned to respond to the changing reimbursement environment because our product offerings are innovative, patient-focused and cost-effective. We have historically been able to reduce our costs through scalable manufacturing, better sourcing, continuous innovation, and reliability improvements, as well as innovations that reduce our product service costs by minimizing exchanges, such as user replaceable batteries. As a result of design changes, supplier negotiations, bringing manufacturing and assembly largely in-house and our commitment to driving efficient manufacturing processes, we have reduced our overall system cost 58% from 2009 to 2017. We intend to continue to seek ways to reduce our cost of revenue through manufacturing and design improvements.

Basis of presentation

The following describes the line items set forth in our consolidated statements of comprehensive income.

Revenue

We classify our revenue in two main categories: sales revenue and rental revenue. There will be fluctuations in mix between business-to-business sales, direct-to-consumer sales and rental revenue from period-to-period. Inogen One and Inogen At Home system selling prices and gross margins may fluctuate as we introduce new products, reduce our product costs, have changes in purchase volumes, and as currency variations occur. For example, the gross margin for our Inogen One G4 system is higher than our Inogen One G3 system due to lower manufacturing costs and similar average selling prices. Thus, to the extent our sales of our Inogen One G4 systems are higher than sales of our Inogen One G3 systems, our overall gross margins should improve and, conversely, to the extent our sales of our Inogen One G3 systems are higher than sales of our Inogen One G4 systems, our overall gross margins should decline. Quarter-over-quarter results may vary due to seasonality in both the international and domestic markets. For example, we typically experience higher total sales in the second and third quarter, as a result of consumers traveling and vacationing during warmer weather in the spring and summer months, but this may vary year-over-year. As more HME providers adopt portable oxygen concentrators in their businesses, we expect our historical seasonality in the domestic business-to-business channel could change as well, which was previously influenced mainly by consumer buying patterns. Direct-to-consumer sales seasonality may also be impacted by the number of sales representatives and the amount of marketing spend in each quarter.

Sales revenue

Our sales revenue is primarily derived from the sale of our Inogen One systems, Inogen At Home systems, and related accessories to individual consumers, our private label partner, HME providers, distributors and resellers worldwide. Sales revenue is classified into two areas: business-to-business sales and direct-to-consumer sales. For the three months ended June 30, 2018 and June 30, 2017, business-to-business sales as a percentage of total sales revenue were 58.4% and 62.2%, respectively. For the six months ended June 30, 2018 and June 30, 2017, business-to-business sales as a percentage of total sales revenue were 59.6% and 62.5%, respectively. Generally, our direct-to-consumer sales have higher gross margins than our business-to-business sales.

We also offer a lifetime warranty for direct-to-consumer sales of our portable concentrators. For a fixed price, we agree to provide a fully functional portable oxygen concentrator for the remaining life of the patient. Lifetime warranties are only offered to patients upon the initial sale of portable oxygen concentrators by the Company and are non-transferable. Lifetime warranties are considered to be a distinct performance obligation that are accounted for separately from the sale of portable oxygen concentrators with a standard warranty of three years.

The revenue is allocated to the distinct lifetime warranty performance obligation based on a relative stand-alone selling price (SSP) method. We have vendor-specific objective evidence of the selling price for our equipment. To determine the selling price of the lifetime warranty, we use our best estimate of the SSP for the distinct performance obligation as the lifetime warranty is neither separately priced nor is the selling price available through third-party evidence. To calculate the selling price associated with the lifetime warranties, management considered the profit margins of the overall business, the average estimated cost of lifetime warranties and the price of extended warranties. Revenue from the distinct lifetime warranty is deferred after the delivery of the equipment for three years and recognized on a straight-line basis during the fourth and fifth year, which is the estimated usage period of the contract based on the average patient life expectancy.

Other sales revenue consists of repair services and freight revenue for product shipments.

Rental revenue

Our rental revenue is primarily derived from the rental of our Inogen One and Inogen At Home systems to patients through reimbursement from Medicare, private payors and Medicaid, which typically also includes a patient responsibility component for patient co-insurance and deductibles. We expect our rental revenue to be down approximately 10% in 2018 as compared to 2017, primarily due to our continued focus on sales instead of rentals. Medicare reimbursement rates in 2018 were impacted by a roughly 1.2% decline in monthly stationary rates in non-competitive bidding areas due to a fee schedule adjustment. In addition, effective June 1, 2018 Medicare reimbursement rates in rural and non-contiguous areas not subject to competitive bidding increased to the previous rates effective December 31, 2017. We estimate rental revenue in 2018 will increase by approximately $0.5 million associated with this interim final rule. We also expect that our rental revenue will be impacted by the number of sales representatives, the level of and response from potential customers to direct-to-consumer marketing spend, product launches, and other uncontrollable factors such as changes in the market and competition.

We recognize equipment rental revenue over the non-cancelable lease term, which is one month, less estimated adjustments, in accordance with ASC 840 — Leases. We have a separate contract with each patient that is not subject to a master lease agreement with any payor. The lease term begins on the date products are shipped to patients and is recorded at amounts estimated to be received under reimbursement arrangements with third-party payors, including Medicare, private payors, and Medicaid. Due to the nature of the industry and the reimbursement environment in which we operate, certain estimates are required to record net revenue and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information

becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review. Amounts billed but not earned due to the timing of the billing cycle are deferred and recognized in revenue on a straight-line basis over the monthly billing period. For example, if the first day of the billing period does not fall on the first of the month, then a portion of the monthly billing period will fall in the subsequent month and the related revenue and cost would be deferred based on the service days in the following month. Included in rental revenue are unbilled amounts for which the revenue recognition criteria had been met as of period-end but were not billed. The estimate of unbilled rental revenue accrual is reported net of adjustments that are based on historical trends and estimates of future collectability.

Cost of revenue

Cost of sales revenue

Cost of sales revenue consists primarily of costs incurred in the production process, including costs of component materials, assembly labor and overhead, warranty, provisions for slow-moving and obsolete inventory, rework and delivery costs for items sold. Labor and overhead expenses consist primarily of personnel-related expenses, including wages, bonuses, benefits, and stock-based compensation for manufacturing, logistics, repair and quality assurance employees, and temporary labor. They also include manufacturing freight in, depreciation expense, facilities costs and materials. We provide a 3-year, 5-year or lifetime warranty on Inogen One systems sold and a 3-year warranty on Inogen At Home systems sold. We established a reserve for the cost of future warranty repairs based on historical warranty repair costs incurred as well as historical failure rates. Provisions for warranty obligations, which are included in cost of sales revenue, are provided for at the time of revenue recognition.

We expect the average unit costs of our Inogen One and Inogen At Home systems to continue to decline in future periods as a result of our ongoing efforts to develop lower-cost systems, negotiate with our suppliers, improve our manufacturing processes, and increase production volume and yields. We also signed an additional lease in Richardson, Texas to expand our current manufacturing facilities by approximately 23,000 square feet due to increased production volumes. While we are currently evaluating the potential impact of recently announced tariffs being considered by the United States on imported aluminum and Chinese goods on the Company's supply chain, such changes may increase our average unit cost. We expect sales gross margin percentage to fluctuate over time based on the sales channel mix, product mix, and changes in average selling prices and cost per unit.

The current economic environment has introduced greater uncertainty with respect to potential trade regulations, including changes to United States policies related to global trade and tariffs. The Company is monitoring the recently announced Section 301 tariffs being imposed by the United States on certain imported Chinese materials and products in addition to potential retaliatory responses from other nations. While we currently expect the overall financial impact to our business from the recently announced tariffs to be immaterial, we will continue to monitor any new tariff proposals and economic policy changes. Such changes may increase our costs or require us to modify the Company's current supply chain.

Cost of rental revenue

Cost of rental revenue consists primarily of depreciation expense; service costs for rental patients, including rework costs, material, labor, freight, and consumable disposables; and logistics costs.

We expect rental gross margin percentage to be flat or slightly increase in 2018 compared to 2017. We expect the average cost of rental revenue per patient to decline in future periods as a result of our ongoing efforts to reduce average unit costs of our systems, including reductions in depreciation, service costs, and logistics costs.

Operating expense

Research and development

Our research and development expense consists primarily of personnel-related expenses, including wages, bonuses, benefits and stock-based compensation for research and development and engineering employees, allocated facility costs, laboratory supplies, product development materials, consulting fees and related costs, and testing costs for new product launches and enhancements to existing products. We have made substantial investments in research and development since our inception. Our research and development efforts have focused primarily on the tasks required

to enhance our technologies and to support development and commercialization of new and existing products. We plan to continue to invest in research and development activities to stay at the forefront of patient preference in oxygen therapy devices. We expect research and development expense to increase in absolute dollars in future periods as we continue to invest in our engineering and technology teams to support our new and enhanced product research and development efforts and manufacturing line support.

Sales and marketing

Our sales and marketing expense primarily supports our direct-to-consumer strategy and consists mainly of personnel-related expenses, including wages, bonuses, commissions, benefits, and stock-based compensation for sales, marketing, customer service and clinical service employees. It also includes expenses for media and advertising, printing, informational kits, dues and fees, including credit card fees, sales promotional and marketing activities, travel and entertainment expenses as well as allocated facilities costs. Sales and marketing expense increased throughout 2017, primarily due to an increase in the sales force and marketing expenses, and we expect a further increase in 2018 as we continue to invest in our business, including expanding our sales and sales support team, increasing media spend to drive consumer awareness, and increasing patient support costs as our patient and customer base increases.

In addition, we implemented a new customer relationship management (CRM) system in the second quarter of 2017 which has increased our sales and marketing costs, but we believe will help improve sales and customer service productivity. We also opened a new facility in Cleveland, Ohio in the third quarter of 2017. In that facility, we expect to have approximately 500 employees by year-end 2020 with at least two-thirds of those employees expected to be in sales, which is expected to increase our sales and marketing costs. However, we are expecting to receive certain partially offsetting business development incentives of up to $3.5 million based on our forecasted headcount additions and facility tenant improvement costs. We also have established a physical presence in Europe by acquiring our former distributor, MedSupport on May 4, 2017. This acquisition is expected to increase sales and marketing costs but is also expected to improve customer service and repair services in the European markets.

General and administrative

Our general and administrative expense consists primarily of personnel-related expenses, including wages, bonuses, benefits, and stock-based compensation for employees in our compliance, finance, medical billing, human resources, and information technology departments as well as facilities costs, bad debt expense, and board of directors' expenses, including stock-based compensation. In addition, general and administrative expense includes professional services, such as legal, patent registration and defense costs, insurance, consulting and accounting services, including audit and tax services, and travel and entertainment expenses.

We expect general and administrative expense to increase in future periods as the number of administrative personnel grows and we continue to introduce new products, broaden our customer base and grow our business. We expect general and administrative expense to increase in absolute dollars as we continue to invest in corporate infrastructure to support our growth including personnel-related expenses, professional services fees and compliance costs associated with operating as a public company. Those costs include increases in our accounting, human resources, IT personnel, additional consulting, legal and accounting fees, insurance costs, board members' compensation and the costs of maintaining compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

Other income (expense), net

Our other income (expense), net consists primarily of foreign currency gains and (losses) as well as interest income earned on cash equivalents and marketable securities.

Income taxes

We account for income taxes in accordance with ASC 740—Income Taxes. Under ASC 740, income taxes are recognized for the amount of taxes payable or refundable for the current period and deferred tax liabilities and assets are recognized for the future tax consequences of transactions that have been recognized in our consolidated financial statements or tax returns. A valuation allowance is provided when it is more likely than not that some portion, or all, of the deferred tax asset will not be realized.

We account for uncertainties in income tax in accordance with ASC 740-10—Accounting for Uncertainty in Income Taxes. ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This accounting standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The accounting for stock-based compensation will increase or decrease our effective tax rate based upon the difference between our stock-based compensation expense and the deductions taken on our U.S. tax return, which depends upon the stock price at the time of employee option exercise or award vesting. We recognize excess tax

benefits on a discrete basis and we anticipate our effective tax rate will vary from quarter-to-quarter depending on our stock price in each period.

Results of operations

Comparison of three months ended June 30, 2018 and June 30, 2017

Revenue

(amounts in thousands)	Three months ended June 30, 2018	2017	Change 2018 vs. 2017 $	%	% of Revenue 2018	2017
Sales revenue	$91,987	$58,038	$33,949	58.5 %	94.6 %	90.5 %
Rental revenue	5,251	6,083	(832)	-13.7%	5.4 %	9.5 %
Total revenue	$97,238	$64,121	$33,117	51.6 %	100.0%	100.0%

Sales revenue increased $33.9 million for the three months ended June 30, 2018 from the three months ended June 30, 2017, or an increase of 58.5% over the comparable period. The increase was primarily attributable to a 22,300-unit increase in the number of oxygen systems sold. We sold approximately 54,700 oxygen systems during the three months ended June 30, 2018 compared to approximately 32,400 oxygen systems sold during the three months ended June 30, 2017, or an increase of 68.8%. The increase in the number of systems sold resulted mainly from an increase in direct-to-consumer sales in the United States, primarily due to an increase in sales representatives as well as increased sales and marketing expenditures, and an increase in worldwide business-to-business sales, primarily due to traditional HME purchases and continued strong private label demand.

Rental revenue decreased $0.8 million for the three months ended June 30, 2018 from the three months ended June 30, 2017, or a decrease of 13.7% from the comparable period. The decrease in rental revenue was primarily related to a decline in rental patients on service which declined 11.8% in the comparative period.

(amounts in thousands)	Three months ended June 30,		Change 2018 vs. 2017		% of Revenue	
Revenue by region and category	2018	2017	$	%	2018	2017
Business-to-business domestic sales	$32,943	$21,154	$11,789	55.7 %	33.9 %	33.0 %
Business-to-business international sales	20,759	14,919	5,840	39.1 %	21.3 %	23.3 %
Direct-to-consumer domestic sales	38,285	21,965	16,320	74.3 %	39.4 %	34.2 %
Direct-to-consumer domestic rentals	5,251	6,083	(832)	-13.7%	5.4 %	9.5 %
Total revenue	$97,238	$64,121	$33,117	51.6 %	100.0%	100.0%

Domestic sales in direct-to-consumer and business-to-business channels increased 74.3% and 55.7%, respectively, for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. The increase in direct-to-consumer sales was primarily due to the hiring of additional inside sales representatives, increased marketing expenditures, our expansion of marketing strategies, and our continued focus on direct-to-consumer sales with more selective new rental patient set-ups. We also benefited from increased direct-to-consumer sales associated with the direct-to-consumer pricing trial and subsequent lowering of retail pricing effective June 1, 2018. The increase in domestic business-to-business sales was primarily the result of increased demand from our private label partner and traditional HME providers, and increased consumer demand for our products due to our marketing efforts as well as the marketing efforts of our business partners.

Business-to-business international sales increased 39.1% for the three months ended June 30, 2018 compared to the three months ended June 30, 2017, primarily due to increases in sales from our partners in Europe and favorable currency exchange rates. As of June 30, 2018, we sold our products in 46 countries outside of the United States, and we plan to continue to expand our presence in other countries as the opportunities present themselves. Of our international sales revenue in the three months ended June 30, 2018, 88.3% was sold in Europe versus 87.6% in the comparative period in 2017. We also acquired our former distributor, MedSupport, in May of 2017, which also contributed to increased international revenues in the second quarter of 2018.

In future periods, sales may be impacted by seasonal factors. For example, we typically experience higher total sales in the second and third quarter, as a result of consumers traveling and vacationing during warmer weather in the spring and summer months, but this may vary year-over-year. As more HME providers adopt portable oxygen concentrators in their businesses, we expect that this could change our historical seasonality in the domestic

business-to- business channel as well, which was previously influenced mainly by consumer buying patterns. Direct-to-consumer sales seasonality may also be impacted by the number of sales representatives and the amount of marketing spend in each quarter.

Cost of revenue and gross profit

(amounts in thousands)	Three months ended June 30, 2018	2017	Change 2018 vs. 2017 $	%	% of Revenue 2018	2017
Cost of sales revenue	$44,968	$27,993				