Inogen Inc
Form 10-Q
May 13, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value	The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act: None

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 x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.   x

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

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

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

As of April 30, 2014, the registrant had 18,192,534 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.

Balance Sheets

(unaudited)

(amounts in thousands)

	March 31, 2014	December 31, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 59,550	$ 13,521
Accounts receivable, net of allowances of $3,417 and $3,390 at March 31, 2014 and December 31, 2013, respectively	18,084	10,231
Inventories, net of allowances of $110 and $100 at March 31, 2014 and December 31, 2013, respectively	4,651	4,248
Deferred cost of rental revenue	283	289
Income tax receivable	—	87
Deferred tax asset-current	3,923	3,923
Prepaid expenses and other current assets	959	531
Total current assets	87,450	32,830
Property and equipment		
Rental equipment, net of allowances of $282 and $156 at March 31, 2014 and December 31, 2013, respectively	39,832	37,573
Manufacturing equipment and tooling	2,584	2,551
Computer equipment and software	3,228	2,973
Furniture and equipment	603	601
Leasehold improvements	888	887
Construction in process	971	1,093

Total property and equipment	48,106	45,678
Less accumulated depreciation	(18,282)	(15,956)
Property and equipment, net	29,824	29,722
Intangible assets, net	345	215
Deferred tax asset - noncurrent	17,807	17,865
Other assets	80	1,765
Total assets	$ 135,506	$ 82,397

See accompanying condensed notes to the financial statements.

Inogen, Inc.

Balance Sheets (continued)

(unaudited)

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

	March 31, 2014	December 31, 2013
Liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)		
Current liabilities		
Accounts payable and accrued expenses	$10,411	$9,219
Accrued payroll	3,829	2,898
Current portion of long-term debt	5,038	5,258
Warranty reserve	490	420
Deferred revenue	1,716	1,487
Income tax payable	432	—
Total current liabilities	21,916	19,282
Long-term liabilities		
Warranty reserve-noncurrent	431	389
Preferred stock warrant liability	—	260
Deferred revenue-noncurrent	1,104	776
Long-term debt, net of current portion	4,151	5,391
Total liabilities	27,602	26,098
Commitments and contingencies (Note 5)		
Redeemable convertible preferred stock		
Preferred stock, $0.001 par value per share; 10,000,000 shares authorized; 0 and 9,541,631 shares issued and outstanding; liquidation preference of $0 and $136,660 at March 31, 2014 and December 31, 2013, respectively	—	118,671
Stockholders' equity (deficit)		
Preferred stock, $0.001 par value per share; 100,000 shares authorized; 0 and 66,666 shares issued and outstanding; liquidation preference of $0 and $250 at March 31, 2014 and December 31, 2013, respectively	—	247
Common stock, $0.001 par value per share; 60,000,000 shares authorized for both periods; 18,151,551 and 280,974 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	18	1
Additional paid-in-capital	170,517	—
Accumulated deficit	(62,631)	(62,620)
Total stockholders' equity (deficit)	107,904	(62,372)
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	$135,506	$82,397

See accompanying condensed notes to the financial statements.

Inogen, Inc.

Statements of Operations

(unaudited)

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

	Three months ended March 31, 2014	2013
Revenue		
Sales revenue	$14,857	$8,895
Rental revenue	8,776	6,852
Total revenue	23,633	15,747
Cost of revenue		
Cost of sales revenue	7,541	5,191
Cost of rental revenue, including depreciation of $2,257 and $1,342, respectively	4,154	2,439
Total cost of revenue	11,695	7,630
Gross profit	11,938	8,117
Operating expenses		
Research and development	635	503
Sales and marketing	5,705	4,147
General and administrative	4,049	2,834
Total operating expenses	10,389	7,484
Income from operations	1,549	633
Other income (expense)		
Interest expense	(133)	(104)
Interest income	6	3
Decrease in fair value of preferred stock warrant liability	36	20
Other income	7	209
Total other income (expense), net	(84)	128
Income before provision for income taxes	1,465	761
Provision for income taxes	577	31
Net income	$888	$730
Less deemed dividend on redeemable convertible preferred stock	(987)	(1,723)
Net loss attributable to common stockholders	$(99)	$(993)
Basic net loss per share attributable to common stockholders	$(0.01)	$(3.65)
Diluted net loss per share attributable to common stockholders	$(0.01)	$(3.65)
Weighted-average number of shares used in calculating loss per share		
attributable to common stockholders - basic common	9,437,525	272,226
attributable to common stockholders - dilutive common	9,437,525	272,226

See accompanying condensed notes to the financial statements.

Inogen, Inc.

Statements of Redeemable Convertible Preferred Stock

(unaudited)

(amounts in thousands, except share amounts)

Series B redeemable convertible preferred stock Shares	Amount	Series C redeemable convertible preferred stock Shares	Amount	Series D redeemable convertible preferred stock Shares	Amount	Series E redeemable convertible preferred stock Shares	Amount	Series F redeemable convertible preferred stock Shares	Amount	Series G redeemable convertible preferred stock Shares	Amount
,511	$5,056	365,903	$6,460	1,487,225	$32,571	1,634,874	$28,044	2,701,957	$14,055	2,840,260	$23,15
	—	—	—	39,510	909	—	—	—	—	—	—
	—	—	—	—	—	—	268	—	376	—	1,079
,511	5,056	365,903	6,460	1,526,735	33,480	1,634,874	28,312	2,701,957	14,431	2,840,260	24,23
	—	—	—	46,391	1,139	—	—	—	—	—	—
	—	—	—	—	—	—	818	—	1,189	—	3,548
,511	5,056	365,903	6,460	1,573,126	34,619	1,634,874	29,130	2,701,957	15,620	2,840,260	27,78
	—	11,094	279	11,415	314	—	—	—	—	—	—
	—	—	—	—	—	—	139	—	207	—	641

5,511)	(5,056)	(376,997)	(6,739)	(1,584,541)	(34,933)	(1,634,874)	(29,269)	(2,701,957)	(15,827)	(2,840,260)	(28,4
	$—	—	$—	—	$—	—	$—	—	$—	—	$—

See accompanying condensed notes to the financial statements.

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Inogen, Inc.

Statements of Stockholders' Equity (Deficit)

(unaudited)

(amounts in thousands, except share amounts)

	Series A convertible preferred stock		Common stock		Additional paid-in	Accumulated	Total stockholders' equity
	Shares	Amount	Shares	Amount	capital	deficit	(deficit)
Balance, December 31, 2012	66,666	$ 247	272,096	$ 1	$ —	$ (81,018)	$ (80,770)
Stock-based compensation	—	—	—	—	24	—	24
Stock options exercised	—	—	222	—	1	—	1
Deemed dividend on redeemable convertible preferred stock	—	—	—	—	(25)	(1,698)	(1,723)
Net income	—	—	—	—	—	730	730
Balance, March 31, 2013	66,666	247	272,318	1	—	(81,986)	(81,738)
Stock-based compensation	—	—	—	—	206	—	206
Stock options exercised	—	—	8,656	—	9	—	9
Warrants exercised - preferred	—	—	—	—	1	—	1
Deemed dividend on redeemable convertible preferred stock	—	—	—	—	(216)	(5,339)	(5,555)
Net income	—	—	—	—	—	24,705	24,705
Balance, December 31, 2013	66,666	247	280,974	1	—	(62,620)	(62,372)
Stock-based compensation	—	—	—	—	43	88	131
Stock options exercised	—	—	8,975	—	11	—	11
Warrants exercised	—	—	72,544	—	22	—	22
Reclassification of warrant liability	—	—		—	76	—	76
Deemed dividend on redeemable convertible preferred stock	—	—	—	—	—	(987)	(987)
Conversion of preferred stock	(66,666)	(247)	14,259,647	14	120,484	—	120,251
Issuance of common stock in connection with initial public offering	—	—	3,529,411	3	49,881	—	49,884
Net income	—	—	—	—	—	888	888
Balance, March 31, 2014	—	$ —	18,151,551	$ 18	$ 170,517	$ (62,631)	$ 107,904

See accompanying condensed notes to the financial statements.

Inogen, Inc.

Statements of Cash Flows

(unaudited)

(amounts in thousands)

	Three months ended March 31, 2014	2013
Cash flows from operating activities		
Net income	$888	$730
Adjustments to reconcile net income to net cash provided by (used in) by operating activities:		
Depreciation and amortization	2,658	1,661
Loss on rental units and other fixed assets	338	73
Provision for sales returns	948	362
Provision for doubtful accounts	196	482
Provision for rental revenue adjustments	1,672	1,159
Provision for inventory obsolescence	26	41
Stock-based compensation expense	131	24
Deferred tax assets	58	—
Decrease in fair value of preferred stock warrant liability	(36)	(20)
Changes in operating assets and liabilities		
Accounts receivable	(10,669)	(3,169)
Inventories	(429)	11
Deferred costs of rental revenue	6	(4)
Prepaid expenses and other current assets	(428)	(189)
Accounts payable and accrued expenses	1,193	797
Accrued payroll	931	325
Warranty reserve	112	213
Deferred revenue	556	166
Income tax receivable	87	31
Income tax payable	432	—
Net cash provided by (used in) operating activities	(1,330)	2,693
Cash flows from investing activities		
Investment in intangible assets	(169)	—
Production of rental equipment	(2,890)	(3,162)
Purchases of property and equipment	(169)	(406)
Refund of deposit	—	(1)
Net cash used in investing activities	(3,228)	(3,569)
Cash flows from financing activities		
Proceeds from redeemable convertible preferred stock warrants and common stock warrants exercised	467	865
Proceeds from stock options exercised	11	1
Proceeds from initial public offering	56,471	—
Costs associated with initial public offering	(4,902)	—

Repayments of debt from investment in intangible assets	(53)	(54)
Repayment of borrowings	(1,407)	(917)
Net cash provided by (used in) financing activities	50,587	(105)
Net increase (decrease) in cash and cash equivalents	46,029	(981)
Cash and cash equivalents, beginning of year	13,521	15,112
Cash and cash equivalents, end of period	$59,550	$14,131
Supplemental disclosures of cash flow information		
Cash paid during the period for interest	132	107
Cash paid during the period for income taxes	39	14
Non-cash transactions:		
Deemed dividend on redeemable convertible preferred stock	987	1,723

See accompanying condensed notes to the financial statements.

Inogen, Inc.

Condensed Notes to the Financial Statements

(unaudited)

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

1. General

a) Basis of Presentation
The unaudited condensed financial statements have been prepared on the same basis as the annual audited financial statements and, in the opinion of management, reflect all adjustments necessary for a fair presentation for each of the periods presented. The results of operations for interim periods are not necessarily indicative of results to be achieved for full fiscal years or other interim periods.

Inogen, Inc. (Company or Inogen) was incorporated in Delaware on November 27, 2001. The Company is a medical technology company that develops, manufactures and markets innovative portable oxygen concentrators used for supplemental long-term oxygen therapy by patients with chronic obstructive pulmonary disease, or COPD, and other chronic respiratory conditions. The Company's proprietary Inogen One systems are designed to address the quality-of-life and other shortcomings of the traditional oxygen therapy model, which Inogen calls the delivery model. Traditionally, oxygen therapy patients have relied upon stationary oxygen concentrator systems in the home in conjunction with regular deliveries of oxygen tanks or cylinders for ambulatory, or mobile, use, limiting their mobility and requiring them to plan activities outside of their homes around delivery schedules and a finite oxygen supply. The Company's Inogens One systems concentrate the air around them to offer a single source of supplemental oxygen anytime, anywhere in devices weighing approximately five to seven pounds. Inogen's products eliminate the need for oxygen deliveries, as well as regular use of a stationary concentrator, thereby improving patient quality-of-life and fostering patient mobility.

As contemplated by the Securities and Exchange Commission (SEC) under Rule 10-01 of Regulation S-X, the accompanying financial statements and related footnotes have been condensed and do not contain certain information that will be included in the Company's annual financial statements and footnotes thereto. For further information refer to the financial statements and related footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC on April 1, 2014 (Annual Report).

b) Use of Estimates
The preparation of the Company's condensed financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in these condensed financial statements and accompanying notes. 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 inventory and rental asset valuations and write-downs, accounts receivable reserves and allowance for bad debts, returns and adjustments, stock compensation expense, impairment assessments, depreciation and amortization, income tax provision and uncertain tax positions, fair value of financial instruments, and fair values of acquired intangibles. Actual results could differ materially from these estimates.

c) Reclassifications

Certain reclassifications have been made to prior years to conform to current period financial statement presentation with no effect on previously reported financial position, results of operations or cash flows.

d) Initial Public Offering (IPO)

The Company completed an initial public offering on February 20, 2014, and sold 3,529,411 shares to the public for $16.00 per share. In addition, to this offering the selling shareholders sold 982,302 shares for a combined total of 4,511,713 actively trading upon the completion of the offering. The Company netted approximately $49,668 after the underwriters discount and other associated expenses. The Company's outstanding redeemable convertible preferred stock and non-redeemable preferred stock were all converted to common stock. As of March 31, 2014, the Company had 18,151,551 shares of common stock outstanding.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

2. Summary of significant accounting policies

Sales 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 Statement of Operations, comes from service contracts, extended warranty contracts and freight revenue for product shipments.

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

Revenue from the sales of the Company's services is recognized when no significant obligations remain undelivered and collection of the receivables is reasonably assured. The Company offers extended service contracts on its Inogen One concentrator line for periods ranging from 12 to 24 months after the end of the standard warranty period. Revenue from these extended service contracts is recognized in income on a straight-line basis over the contract period.

Accruals for estimated standard warranty expenses are made at the time that the associated revenue is recognized. The provisions for estimated returns, discounts and warranty obligations are made based on known claims and discount commitments and estimates of additional returns and warranty obligations based on historical data and future expectations. The Company had accrued $921 and $809 to provide for future warranty costs at March 31, 2014 and December 31, 2013, respectively.

The Company also offers a lifetime warranty for direct-to-consumer sales. For a fixed price, the Company agrees to provide a fully functional oxygen concentrator for the remaining life of the patient. Lifetime warranties are only offered to patients upon the initial sale of oxygen equipment by the Company and are non-transferable. Product sales with lifetime warranties are considered to be multiple element arrangements within the scope of the Accounting Standards Codification (ASC) 605-25—Revenue Recognition-Multiple-Element Arrangements.

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

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

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

Shipping and handling costs for sold products and rental assets, shipped to the Company’s customers are included on the Statements of Operations as part of cost of sales revenue and cost of rental revenue, respectively.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

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

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 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. To date, the Company has not deferred any amounts associated with the capped rental period. Amounts related to the capped rental period have not been material in the periods presented.

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

Rental revenue is recognized as earned, less estimated adjustments. Revenue not billed at the end of the period is reviewed for the likelihood of collections and accrued. The rental revenue stream is not guaranteed and payment will cease if the patient no longer needs oxygen or returns the equipment. Revenue recognized is at full estimated allowable amounts; transfers to secondary insurances or patient responsibility have no net effect on revenue. Rental revenue is earned for that month if the patient is on service on the first day of the 30-day period commencing on the recurring date of service for a particular claim, regardless if there is a change in condition 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 unbilled rental revenue accrual is based on historical trends and estimates of future collectability.

Fair value of financial instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, debt and warrants. The carrying values of cash and cash equivalents, accounts receivable and accounts payable and accrued expenses approximate fair values based on the short-term nature of these financial instruments.

The fair value of the Company's debt approximates carrying value based on the Company's current incremental borrowing rate for similar types of borrowing arrangements. Imputed interest associated with the Company's non-interest bearing debt is insignificant and has been appropriate recognized in the respective periods.

The fair value of the Company's preferred stock warrant liability was estimated using a Monte Carlo valuation model.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

Fair value accounting

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 should be determined based on assumptions that market participants would use in pricing the asset or liability. 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 following table summarizes fair value measurements by level at December 31, 2013 for the liabilities measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3	Total
Preferred stock warrant liability	$ —	$ —	$ 260	$ 260
Total liabilities	$ —	$ —	$ 260	$ 260

The following table summarizes the fair value measurements using significant Level 3 inputs, and changes therein, for the three months ended March 31, 2014 and March 31, 2013:

Warrant

	liability
Balance as of December 31, 2012	$ 164
Fair value of preferred stock warrants exercised	(31)
Change in fair value	(20)
Balance as of March 31, 2013	$ 113

	Warrant liability
Balance as of December 31, 2013	$ 260
Fair value of preferred stock warrants exercised	(148)
Change in fair value	(36)
Reclassification of liability to additional paid in capital	(76)
Balance as of March 31, 2014	$ —

The preferred stock warrant liability was marked to market at each reporting date and the fair value was estimated using a Monte Carlo valuation model, which takes into consideration the market values of comparable public companies, considering among other factors, the use of multiples of earnings, and adjusted to reflect the restrictions on the ability of the Company's shares to trade in an active market.

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.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

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

The Company does not allow returns from providers. Provision for sales returns applies to direct-to-consumer sales only. This reserve is calculated based on actual historical return rates under the Company’s 30-day return program and is applied to the sales revenue for direct-to-consumer sales for the last month of the quarter reported.

The Company also records an allowance for rental revenue adjustments and write-offs, which is recorded as a reduction of rental revenue and rental accounts receivable balances. These adjustments and write-offs result from contractual adjustments, audit adjustments, untimely claims filings or 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 becoming realizable. The reserve is based on historical revenue adjustments as a percentage of rental revenue billed 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 adjustments, the rental revenue adjustments account (contra rental revenue account) is charged.

At March 31, 2014 and December 31, 2013, included in accounts receivable on the balance sheets were earned but unbilled receivables of $2,413 and $1,435, respectively.

Concentration of credit risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash and cash equivalents 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 and short-term investments to date.

Concentration of customers and vendors

The Company sells its products to home medical equipment providers in the United States and in foreign countries on a credit basis. No single customer represented more than 10% of our total revenue for the three months ended March 31, 2014 and March 31, 2013.

The Company also rents products directly to patients, which resulted in a customer concentration relating to Medicare’s service reimbursement programs. Medicare’s service reimbursement programs (net of patient co-insurance obligations) accounted for 58.0% and 60.4% of rental revenue for the three months ended March 31, 2014 and March

31, 2013, respectively, and based on total revenue were 21.5% and 26.3% for the three months ended March 31, 2014 and March 31, 2013, respectively. Accounts receivable balances relating to Medicare's service reimbursement programs amounted to $6,229 or 34.4% of total accounts receivable at March 31, 2014 as compared to $2,560, or 25.0% of total accounts receivable at December 31, 2013.

The Company currently purchases raw materials from a limited number of vendors, which resulted in a concentration of three major vendors. For the three months ended March 31, 2014, the Company's three major vendors accounted for 18.8%, 17.8%, and 10.5%, respectively, of total raw material purchases. Accounts payable balances for the three major vendors were $1,416, $623, and $541, respectively, or 19.5%, 8.6%, and 7.4%, respectively, of total accounts payable at March 31, 2014.

For the three months ended March 31, 2013, the Company's three major vendors accounted for 14.0%, 13.8% and 12.1%, respectively, of total raw material purchases for the three months ended March 31, 2013. The three major vendors supply the Company with raw materials used to manufacture the Company's products. Accounts payable balances for the three major vendors were $1,268, $666, and $460, respectively, or 18.3%, 9.6%, and 6.7%, respectively, of total accounts payable at December 31, 2013.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

A portion of revenue is earned from sales outside the United States. Non-U.S. revenue is denominated in U.S. dollars. A breakdown of the Company's revenue from U.S. and non-U.S. sources for the three months ended March 31, 2014 and March 31, 2013 is as follows:

	Three Months Ended March 31,	
	2014	2013
U.S. revenue	$19,187	$12,523
Non-U.S. revenue	4,446	3,224
Total revenue	$23,633	$15,747

Inventories

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

	March 31, 2014	December 31, 2013
Raw materials and work-in-progress	$3,995	$ 3,783
Finished goods	766	565
Less: reserves	(110)	(100)
Inventories	$4,651	$ 4,248

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	5 years
Computer equipment and software	3 years
Furniture and equipment	3-5 years
Leasehold improvements	Shorter of 3-10 years or life of underlying lease

Expenditures for additions, improvements and replacements are capitalized and depreciated to a salvage value of zero. Repair and maintenance costs are included in cost of revenue in the Statements of Operations. Repair and maintenance expense, which includes labor, parts and freight for rental equipment was $390 and $260 for the three months ended March 31, 2014 and March 31, 2013, respectively.

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

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

Depreciation and amortization expense related to property and equipment and rental equipment is summarized below for the three month ended March 31, 2014 and March 31, 2013, respectively.

	Three Months Ended March 31,	
Depreciation and amortization	2014	2013
Rental equipment	$2,257	$1,342
Other property and equipment	362	251
Depreciation and amortization	$2,619	$1,593

Property and equipment and rental equipment with association accumulated depreciation is summarized below for March 31, 2014 and December 31, 2013, respectively.

	March 31, 2014	December 31, 2013
Property and equipment		
Rental equipment, net of allowance	$39,832	$ 37,573
Other property and equipment	8,274	8,105
Property and equipment	48,106	45,678
Accumulated depreciation		
Rental equipment	14,508	12,545
Other property and equipment	3,774	3,411
Accumulated depreciation	18,282	15,956
Net property and equipment		
Rental equipment	25,324	25,028
Other property and equipment	4,500	4,694
Property and equipment, net	$29,824	$ 29,722

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 three months and deferred tax liabilities and assets are recognized for the future tax consequences of transactions that have been recognized in the Company's 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 operations as income tax expense. No significant interest or penalties were recognized during the periods presented.

The Company operates in multiple states. The statute of limitations has expired for all tax years prior to 2010 for federal and 2009 to 2010 for various state tax purposes. However, the net operating loss generated on the federal and state tax returns in prior years may be subject to adjustments by the federal and state tax authorities.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

Accounting for stock-based compensation

The Company accounts for its stock-based compensation in accordance with ASC 718, Compensation—Stock Compensation, which establishes accounting for share-based awards, exchanged for employee services and requires companies to expense the estimated fair value of these awards over the requisite employee service period. Stock–based compensation cost is determined at the grant date using the Black-Scholes option pricing model. The value of the award that is ultimately expected to vest is recognized as expense on a straight line basis over the employee's requisite service period.

As part of the provisions of ASC 718, the Company is required to estimate potential forfeitures of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

Business segments

The Company operates in only one business segment – manufacturing, sales, rental and marketing of oxygen concentrators.

Stock Split

On November 11, 2013, the Company's board of directors and stockholders approved a 3:1 reverse stock split. This became effective as of November 12, 2013 and the effect of this event has been reflected in all of the share quantities and per share amounts throughout these financial statements. The shares of common stock retained a par value of $0.001.

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 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 and warrants are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

The shares used to compute basic and diluted net income per share represent the weighted-average common shares outstanding, reduced by the weighted-average unvested common shares subject to repurchase. Further, as the Company's holders of redeemable convertible preferred stock have the right to participate in any dividend declared on the Company's common stock, basic and diluted EPS are potentially subject to computation using the two-class method, under which the Company's undistributed earnings are allocated amongst the holders of common and redeemable convertible preferred stock. However, as the Company recorded a net loss attributable to common stockholders for the three months ended March 31, 2014 and March 31, 2013, a presentation of EPS using the two class method was not necessary.

On February 20, 2014, the Company completed an initial public offering (IPO) of 4,411,763 shares of common stock at a price of $16.00 per share. The Company sold 3,529,411 shares of common stock and certain stockholders sold 882,352 shares of common stock. As of March 7, 2014 the underwriters elected to purchase 99,550 additional shares of common stock at the IPO price from the certain selling shareholders. All redeemable convertible preferred stock and non-redeemable preferred stock-outstanding as of the IPO automatically converted into 14,259,647 shares of common stock.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

The computation of EPS is as follows:

	Three months ended March 31,	
	2014	2013
Numerator—basic:		
Net income	$888	$730
Less deemed dividend on redeemable preferred stock	(987)	(1,723)
Net loss after deemed dividend on redeemable preferred stock	$(99)	$(993)
Net loss per share - basic common stock	$(0.01)	$(3.65)
Net loss per shares - basic preferred stock	$(0.01)	$(3.65)
Denominator:		
Weighted-average common shares - basic common stock	9,437,525	272,226
Weighted-average common shares - diluted common stock	9,437,525	272,226

The computations of diluted net income applicable to common shareholders exclude redeemable convertible preferred stock, warrants and common stock options which were anti-dilutive for the three months ended March 31, 2014 and March 31, 2013.

3. Intangible assets

During the year ended December 31, 2008, the Company acquired Comfort Life Medical, LLC (Comfort Life). The acquisition resulted in recording an intangible asset in the amount of $92 related to the Medicare license held by the acquired company. The Company amortizes this intangible asset over its estimated useful life of ten years. As of March 31, 2014 and March 31, 2013, there were no impairments recorded related to this intangible asset. On April 1, 2009, Comfort Life Medical, LLC merged with Inogen, Inc., and was simultaneously dissolved. During the year ended December 31, 2009, the Company was assigned four patents previously held as an exclusive license from Air Products & Chemicals (APC) in exchange for an increase in a long-term liability due to APC of $250. The acquisition of these patents resulted in an intangible asset of $250. During the year ended December 31, 2011, the Company purchased additional patents from APC for a total value of $650. The Company amortizes these intangible assets over an estimated useful life of five years. As of March 31, 2014 and March 31, 2013, there were no impairments recorded related to these intangible assets. The Company recalculated interest and amortization of the period based on adjusted asset and debt.

During the year ended December 31, 2011, the Company acquired Breathe Oxygen Services, LLC. The acquisition resulted in recording an intangible asset in the amount of $66 related to the Medicare license held by the acquired Company that allowed them to operate in the state of Tennessee as well as assets of the Company. On August 29, 2011, Breathe Oxygen Services, LLC merged with Inogen, Inc., and was simultaneously dissolved. The Company amortizes this intangible asset over its estimated useful life of ten years. During the three months ended March 31, 2014 and March 31, 2013, there were no impairments recorded related to this intangible asset. The Company also capitalizes costs incurred for the production of direct response advertising commercials and amortizes these intangible assets over a useful life of two years. During the three months ended March 31, 2014, the Company paid $169 for its patient setup video, website development and redesign and production of commercials.

Amortization expense for intangible assets for the three months ended March 31, 2014 and March 31, 2013 was $39 and $68, respectively.

The following tables represent the changes in net carrying values of the intangibles as of the respective dates:

March 31, 2014	Average estimated useful lives (in years)	Gross carrying amount	Accumulated amortization	Net amount
Licenses	10	$ 185	$ 68	$ 117
Patents	5	723	680	43
Commercial and websites	2	242	57	185
Total		$ 1,150	$ 805	$ 345

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Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

December 31, 2013	Average estimated useful lives (in years)	Gross carrying amount	Accumulated amortization	Net amount
Licenses	10	$ 185	$ 63	$ 122
Patents	5	723	662	61
Commercial	2	73	41	32
Total		$ 981	$ 766	$ 215

4. Long-term debt

Amended and restated credit and term loan agreement

On October 12, 2012, the Company entered into an amended and restated credit and term loan agreement with its current lenders whereby the existing balances and the payback terms were not changed. This transaction did not result in any debt extinguishment losses or gains. The Company did not incur or defer any financing cost directly related to the credit and term loan agreement. Due to the completion of the IPO during the term of this facility, a fee equal to 1% of the facility amount of $120, which was paid to the lenders in March of 2014, and was included in general and administrative expenses in the Company’s Statements of Operations for the current year.

The amended and restated credit and term loan agreement with the Company’s current lenders provides for new borrowings of up to $12,000, secured by substantially all of the Company’s assets. The amended and restated credit and term loan agreement provides for the existing term loan facility for rental assets amounting to up to $3,000 (Term Loan A), a term loan facility for rental assets amounting to up to $8,000 (Term Loan B), a new term loan facility for rental assets amounting to up to $12,000 (Term Loan C), and an accounts receivable revolving line of credit amounting to up to $1,000 based on 80% of eligible accounts receivable, as defined (AR Revolver).

Interest for all the term loans are payable monthly. Principal is payable monthly. Each term loan bears interest at the Base Rate, which is a rate equal to the applicable margin plus the greater of (i) the prime rate, (ii) the federal funds effective rate, as defined in the agreement, plus 1% and (iii) the daily adjusting LIBOR rate, plus 1%. The applicable margins for Term Loans A, B, and C are 1.25%, 2.5% and 2.25%, respectively.

The Term Loan A facility of $3,000 is presented net of principal payments that began in May 2011. The net balances of this term loan facility were $167 and $417 as of March 31, 2014 and December 31, 2013, respectively.

The Term Loan B facility for $8,000 is presented net of principal payments that began in May 2012. The net balances of this term loan facility were $3,111 and $3,778 as of March 31, 2014 and December 31, 2013, respectively.

The Term Loan C facility for $12,000 is presented net of principal payments that began November, 2013. The net balances were $5,166 and $5,666 as of March 31, 2014 and December 31, 2013, respectively. Payment of principal is payable monthly over a period of 36 months starting November 2013.

The AR Revolver expired on October 13, 2013, and was not renewed by the Company. There were no borrowings under the AR Revolver as of and during the three months ended March 31, 2014.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

The interest rates were 4.5% for Term Loan A, 5.75% for Term Loan B, and 5.5% for Term Loan C at March 31, 2014 and December 31, 2013. As of March 31, 2014 and December 31, 2013, the Company was in compliance with all covenants of the amended and restated credit and term loan agreement.

	March 31, 2014	December 31, 2013
Term Loan A, bearing interest at Base Rate, monthly payments of $83 beginning May 2011 through April 2014	$167	$417
Term Loan B, bearing interest at Base Rate, monthly payments of $222 beginning May 2012 through April 2015	3,111	3,778
Term Loan C bearing interest at Base Rate, monthly payments of $167 beginning November 2013 through October 2016	5,166	5,666
Contractual obligation, bearing imputed interest at prime plus two, quarterly payments of $53 beginning May 2011 through October 2014 and quarterly payments of $81 beginning January 2015 through October 2016	745	788
Subtotal	$9,189	$10,649
Less: current maturities	(5,038)	(5,258)
Long-term debt, net of current portion	$4,151	$5,391

As of March 31, 2014, the minimum aggregate payments due under non-cancelable debt are summarized as follows:

	March 31, 2014
Remaining 9 months of 2014	$3,754
2015	3,378
2016	2,057
Total	$9,189

5. Commitments and contingencies

Leases

The Company leases its offices and certain equipment under operating leases that expire through December 2019. At March 31, 2014, the minimum aggregate payments due under non-cancelable leases are summarized as follows:

	March 31, 2014
Remaining 9 months of 2014	$626
2015	732
2016	335
2017	327
2018	315
Thereafter	313
	$2,648

Rent expense of $207 and $198 was included in the accompanying Statements of Operations for the three months ended March 31, 2014 and March 31, 2013, respectively.

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Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

Warranty obligation

The following table identifies the changes in the Company's aggregate product warranty liabilities for the three months ended March 31, 2014 and March 31, 2013:

	Three Months Ended March 31,	
	2014	2013
Product warranty liability at beginning of period	$809	$447
Accruals for warranties issued	208	88
Adjustments related to preexisting warranties (including changes in estimates)	138	244
Settlements made (in cash or in kind)	(234)	(85)
Product warranty liability at end of period	$921	$694

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 expulsion 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 Company believes that is complies in all material respects with the provisions of those regulations that are applicable to the Company's business.

The Health Insurance Portability and Accountability Act (HIPAA) assures 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 may be subject to significant fines and penalties if found not to be compliant with the provisions outlined in the regulations.

Amended & Restated Employment agreements

On October 1, 2013, the Company entered into an Employment Agreement with the Chief Executive Officer (CEO) including considerations for salary, bonus awards, and severance and change of control benefits upon certain qualifying terminations up to a period of thirty-six months.

On October 1, 2013, the Company has entered into employment agreements with certain key employees including considerations for salary, bonus awards, and severance and change of control benefits upon certain qualifying terminations up to a period of twenty-four months.

Legal proceedings

On November 4, 2011, the Company filed a lawsuit in the United States District Court for the Central District of California against Inova Labs Inc., or Defendant, for infringement of two of our patents. The case, Inogen Inc. v. Inova Labs Inc., Case No. 8:11-cv-01692-JST-AN, or the Lawsuit, involves U.S. Patent Nos. 7,841,343, entitled "Systems and Methods For Delivering Therapeutic Gas to Patients", or the '343 patent, and 6,605,136 entitled "Pressure Swing Adsorption Process Operation And Optimization", or the '136 patent. Inogen alleged in the Lawsuit that certain of Defendant's oxygen concentrators infringe various claims of the '343 and '136 patents. The Lawsuit seeks damages, injunctive relief, costs and attorney fees.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

The Defendant has answered the complaint, denying infringement and asserting various sets of defenses including non-infringement, invalidity and unenforceability, patent misuse, unclean hands, laches and estoppel. The Defendant also filed counterclaims against us alleging patent invalidity, non-infringement and inequitable conduct. The Company denied the allegations in the Defendant's counterclaims and has filed a motion to dismiss Defendant's inequitable conduct counterclaim.

The Defendant filed a request with the U.S. Patent and Trademark Office seeking an inter partes reexamination of the '343 and '136 patents. The Defendant also filed a motion to stay the Lawsuit pending outcome of the reexamination. On March 20, 2012, the Court granted the Defendant's motion to stay the Lawsuit pending outcome of the reexamination and also granted Inogen's motion to dismiss the Defendant's inequitable conduct counterclaim.

The Company is party to various legal proceedings arising in the normal course of business. The Company carries insurance, subject to deductibles under the specified policies, to protect against losses from certain types of legal claims. The Company does not anticipate that any of these proceedings will have a material impact on the Company.

6. Income taxes

The Company operates in multiple states. The statute of limitations has expired for all tax years prior to 2010 for federal and 2009 to 2010 for various state tax purposes. However, the net operating loss generated on the federal and state tax returns in prior years may be subject to adjustments by the federal and state tax authorities. The Company does not expect any material changes to unrecognized tax benefits in the in next 12 months, and has not incurred any tax related penalties or interest.

Income tax expense was $577, an effective tax rate of 39.4% for the three months ended March 31, 2014 compared to $31, an effective tax rate of 4.1% as of March 31, 2013. The variation in the tax rate year over year was primarily driven by the change in the Company's deferred tax asset valuation allowance. As of March 31, 2013, the Company maintained a full valuation allowance against its federal and state deferred tax assets which significantly reduced the Company's effective tax rate. In December of 2013, the Company evaluated its facts and circumstances and concluded that it was appropriate to release $22,909 of the valuation allowance which created a one-time tax benefit of $21,587 for the year ended December 31, 2013. Refer to the Company's 2013 10-K filing for additional information regarding the deferred tax asset valuation allowance. Variations in the tax rate year-over-year was also due to an increase in permanent tax differences related to employee stock option expense.

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.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

7. Convertible preferred stock

A summary of the terms of the various types of redeemable convertible preferred stock at March 31, 2014, and December 31, 2013 is as follows:

Redeemable convertible preferred stock as of March 31, 2014

Series	B	C	D	E	F	G	Total
Shares authorized	500,000	400,000	1,700,000	1,700,000	2,800,000	2,900,000	10,000,000
Shares issued	425,511	376,997	1,584,541	1,634,874	2,701,957	2,840,260	9,564,140
Shares converted	(425,511)	(376,997)	(1,584,541)	(1,634,874)	(2,701,957)	(2,840,260)	(9,564,140)
Shares outstanding	—	—	—	—	—	—	—

Redeemable convertible preferred stock as of December 31, 2013

Series	B	C	D	E	F	G	Total
Shares authorized	500,000	400,000	1,700,000	1,700,000	2,800,000	2,900,000	10,000,000
Shares issued	425,511	365,903	1,573,126	1,634,874	2,701,957	2,840,260	9,541,631
Par value	$0.001	$0.001	$0.001	$0.001	$0.001	$0.001	
Conversion rate	1.45108	1.73014	1.87951	2.69244	1.0000	1.0000	
Liquidation preference per share	$11.880	$17.580	$21.900	$19.224	$7.140	$14.083	
Dividend rate	5%	8%	8%	8%	8%	8%	
Issue date	July 2003	June 2004	July 2005 to July 2007	October 2007 to February 2009	February 2010 to June 2010	March 2012	
Redemption date	January 1,	January 1,	January 1,	January 1,	January 1,	January 1,	

2016	2016	2016	2016	2016	2016

A summary of the terms of non-redeemable convertible preferred stock at March 31, 2014 and December 31, 2013 is as follows:

As of March 31, 2014	
Series	A
Shares authorized	100,000
Share issued	66,666
Shares converted	(66,666)
Shares outstanding	—

As of December 31, 2013	
Series	A
Shares authorized	100,000
Share issued	66,666
Par value	$0.001
Conversion rate	1.01706
Liquidation preference per share	$3.750
Dividend rate	5 %
Issue date	May 2002

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

All outstanding preferred stock automatically converted into common stock in connection with the closing of the IPO. At the closing of the IPO, 9,564,140 shares of redeemable convertible preferred stock and 66,666 shares of convertible preferred stock were automatically converted into 14,259,647 shares of common stock. Following the IPO, all warrants previously exercisable for preferred stock became exercisable for common stock. The previously reported warrant liability associated with the convertible warrants was applied to additional paid-in-capital.

The Company's Series C preferred stock warrants expired in connection with the IPO. As of February 20, 2014, 2,756 Series C preferred stock warrants were forfeited and cancelled since they were not exercised prior to the IPO.

8. Stock incentive plans

The board of directors approved and adopted a 2014 Equity Incentive Plan (2014 Plan) to become effective upon the close of the IPO that occurred on February 20, 2014. A total of 895,346 shares of common stock were reserved for issuance pursuant to the 2014 Plan. In addition, the shares reserved for issuance under the 2014 Plan also includes shares returned to the 2012 Plan as the 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 2012 Plan is 2,328,569 shares). The number of shares available for issuance under the 2014 Plan will also include an annual increase on the first day of each fiscal year beginning in 2015, equal to the least of: (i) 895,346 shares; (ii) 4% of the outstanding shares of common stock as of the last day of the Company's immediately preceding fiscal year; or (iii) such other amount as our board of directors may determine.

The Company had a 2012 Stock Incentive Plan (2012 Plan) under which the Company reserved 1,216,772 shares of common stock, to be issued in connection with stock options and other equity awards. The 2012 Plan provided for option grants at exercise prices not less than 100% of the fair value of common stock on the date of grant. As of February 14, 2014, the 2012 Plan was terminated and the 2014 Plan was created in its place.

Previously, the Company had a 2002 Stock Incentive Plan (2002 Plan), as amended. As of March 12, 2012, the 2002 Plan was terminated and the 2012 Plan was created in its place. On termination, the 2002 Plan had 1,424,540 shares of common stock outstanding. Any shares returned to the 2002 Plan as a result of expiration or termination of equity awards (up to 1,424,646 shares) are added to the 2012 Plan Share reserve.

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

There were no grants issued for the three months ended March 31, 2014. On April 1, 2014, the board approved grants totaling 632,694 shares to board members, executive officers and certain key employees with an exercise price of

$16.62 per share.

The activity for stock options under the Plans for the three months ended March 31, 2014 is as follows:

Series	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, 2013	2,328,675	$0.60 - $8.70	$ 1.94	7.04	$ 10.23
Granted	—	—	—		
Exercised	(8,975)	$0.60 - $8.70	1.29		
Forfeited	(335)	$0.60 - $0.75	0.69		
Expired	(4,799)	$0.60 - $8.37	1.09		
Outstanding as of March 31, 2014	2,314,566	$0.60 - $8.70	$ 1.94	6.80	$ 14.62

Employee stock-based compensation expense for the three months ended March 31, 2014 and March 31, 2013 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures at a rate of 5.7% based on the Company's historical option cancellations. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

For the three months ended March 31, 2014 and March 31, 2013, stock-based compensation expense recognized under ASC 718, included in cost of sales, sales and marketing expense, general and administrative expense, and research and development expense, totaled $122 and $24, respectively.

The board approved and adopted an employee stock purchase plan (ESPP Plan) to be effective upon the completion of the initial public offering that occurred on February 20, 2014. The first offering period of this plan began on March 1, 2014. Enrollment dates will continue on the exercise date and will end on either the first trading date after September 1st or March 1st. There are two offering periods per year. The exercise price will be the lesser of 85% of the stock price on the enrollment date or the purchase date. The total number of shares available for issuance under the ESPP Plan is 179,069. The number of shares available for issuance under the ESPP Plan will be increased on the first day of each fiscal year beginning with the 2015 fiscal year equal to the least of (i) 179,069 shares of common stock, (ii) one-and-a-half percent (1.5%) of the outstanding shares of common stock on the last day of the immediately preceding fiscal year, or (iii) an amount determined by the Administrator. The Company recorded $9 of compensation expense for the three months ended March 31, 2014 associated with this Plan, which is included in the total ASC 718 stock-based compensation expense.

9. Warrants

In connection with certain of its redeemable convertible preferred stock issuances, convertible debt financings, and other financing arrangements the Company had issued warrants for shares of its common stock and various issues of its redeemable convertible preferred stock. Such warrants related to its redeemable convertible preferred stock had been recorded as liabilities as a result of non-standard anti-dilution and redemption rights of the underlying stock and were carried at their estimated fair value using the Monte Carlo valuation model. As of February 14, 2014, the warrants were converted to common stock warrants with no anti-dilution features. The Company revalued the warrants as of the offering date, recorded a gain on the liability through the Statements of Operations, and subsequently reclassified the warrant liability to additional paid-in-capital.

The former Series E redeemable convertible preferred stock warrants convert directly to common stock equivalents with a conversion rate of $2.69244 for a total of 11,367 shares of common stock. The common stock warrants outstanding convert on a one-to-one basis of every warrant to common stock, therefore the 161,295 warrants outstanding as of March 31, 2014 could be exercised into a total of 172,662 shares of common stock.

A summary of outstanding common stock warrants at March 31, 2014 is as follows:

Security	Number of warrants	Exercise price/share	Expiration date

Former Series E redeemable convertible preferred stock warrants	4,222	$ 9.612	2017
Common stock	161,295	0.300	2017-2019
	165,517		

A summary of outstanding warrants at December 31, 2013 is as follows:

Security	Number of warrants	Exercise price/share	Expiration date
Series C redeemable convertible preferred stock warrants	14,215	$ 17.580	2015
Series D redeemable convertible preferred stock warrants	11,415	21.900	2013-2014
Series E redeemable convertible preferred stock warrants	3,120	9.612	2015
Series E redeemable convertible preferred stock warrants	1,102	9.612	2016
Common stock	233,611	0.300	2017-2019
	263,463		

The fair value of the preferred stock warrant liability was $0 and $260 at March 31, 2014 and December 31, 2013, respectively. During the three months ended March 31, 2014 and March 31, 2013, the Company recorded a gain of $36 and $20, respectively, on the change in fair value of the preferred stock warrants. The liability was reclassified to additional paid-in-capital as of February 14, 2014, and the warrants were converted to common stock warrants.

Inogen, Inc.

Condensed Notes to the Financial Statements (continued)

(unaudited)

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

10. Subsequent Events

The compensation committee approved the right to grant 632,694 options to certain board members, executives and key personnel on March 19, 2014 from the 2014 Equity Incentive Plan. The options were granted and issued on April 1, 2014 with a closing stock price of $16.62 per share. In addition key executive officers and employees exercised stock options and were issued common stock of 50,983 shares with stock option prices ranging from $0.60 to $8.70 per share.

On April 22, 2014, the former redeemable convertible Series E preferred stock warrants, that were converted to common stock warrants as of February 14, 2014, were exercised via a cashless exercise and 8,650 shares of common stock was issued.

The Company had additional debt capacity on its Term Loan C facility that would have expired on April 11, 2014. The Company drew the remaining $6,000 in available funds on April 4, 2014. The additional debt was added to the original agreement, and principal will be payable monthly over the remaining period of thirty months of the term agreement which begins in May 2014.

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

Forward Looking Statements

This report and the information incorporated by reference in this report contain “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that concern matters that involve risks and uncertainties that could cause actual results to differ materially from those anticipated or projected in the forward-looking statements. These forward-looking statements are intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact contained in this interim report, including statements regarding future events, our future financial performance, our future business strategy and the plans and objectives of management for future operations, are forward-looking statements. We have attempted to identify forward-looking statements by using words such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “project,” “plan,” “predict,” “ “will,” “would” and similar expressions, or the negative of these expressions, as they relate to us, our management and our industry.

We have based our forward-looking statements on our current expectations and projections about trends affecting our business and industry and other future events. Although we do not make forward-looking statements unless we believe we have a reasonable basis for doing so, we cannot guarantee their accuracy.

Some of the risks, uncertainties and assumptions that may cause actual results to differ from these forward-looking statements are described in Part II, Item 1A of this interim report in the section entitled “Risk Factors,” as well as in our other filings with the SEC. In addition, actual results may differ as a result of additional risks and uncertainties of which we are currently unaware or which we do not currently view as material to our business. We operate in a very competitive and rapidly changing environment. New risk factors emerge from time to time and we cannot predict all such risk factors, nor can we assess the impact of all such risk 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. As a result, actual results may differ materially from the results stated in or implied by our forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements, which reflect our opinions only as of the date of this quarterly report, as a prediction of actual results.

You should read this report in its entirety, together with our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on April 1, 2014 (Annual Report), and the documents that we file as exhibits to these reports and the documents that we incorporate by reference in these reports, with the understanding that our future results may be materially different from what we currently expect. We qualify all of our forward-looking statements by these cautionary statements and we expressly disclaim any intent or obligation to update any forward-looking statements after the date hereof to conform such statements to actual results or to changes in our opinions or expectations, except as required by applicable law or the rules of the NASDAQ Stock Market.

Unless otherwise specifically indicated, all amounts herein are expressed in thousands, except for share quantity, per share data, and unit counts. The following discussion of our financial condition and results of operations should be read together with our condensed financial statements and the accompanying notes to those statements included elsewhere in this document.

Critical accounting policies and significant estimates

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

There have been no material changes in our critical accounting policies and estimates in the preparation of our condensed financial statements during the three months ended March 31, 2014 compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on April 1, 2014.

Overview

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

We believe our direct-to-consumer strategy has been critical to driving patient adoption of our technology. All other portable oxygen concentrator manufacturers access patients through home medical equipment providers, which we believe are disincentivized to encourage portable oxygen concentrator adoption. In order to facilitate the regular delivery and pickup of oxygen tanks, home medical equipment providers have invested in geographically dispersed distribution infrastructures consisting of delivery vehicles, physical locations, and delivery personnel within each area. Because portable oxygen concentrator technology eliminates the need for physical distribution infrastructure but has higher initial equipment costs than oxygen tanks and cylinders, we believe converting to a portable oxygen concentrator model would require both significant restructuring and capital investment for home medical equipment providers. Our direct-to-consumer marketing strategy allows us to sidestep the home medical equipment channel, appeal to patients directly, and capture both the manufacturing and provider margin.

We believe our ability to capture this top-to-bottom margin, combined with our portable oxygen concentrator technology that eliminates the need for the costs associated with oxygen deliveries, gives us a cost structure advantage over our competitors using the delivery model. We derive a majority of our revenue from the sale and rental of our Inogen One systems and related accessories to patients, insurance carriers, home healthcare providers and distributors. We sell multiple configurations of our Inogen One systems with various batteries, accessories, warranties, power cords, and language settings. We also rent our products to Medicare beneficiaries and patients with other insurance coverage to support their oxygen needs as prescribed by a physician as part of a care plan. Our goal is to design, build and market oxygen solutions that redefine how oxygen therapy is delivered. To accomplish this goal and to grow our revenue, we intend to continue to:

Expand our sales and marketing channels. We will continue to expand our sales and marketing through efficiency improvement and/or additional hires and increased consumer awareness to drive our direct-to-consumer revenues. In addition, we are continually looking to increase our personnel capacity and building a larger physician referral channel to facilitate growth in this area.

Invest in our product offerings to develop innovative products. We expended $0.6 million and $0.5 million for the three months ended March 31, 2014 and March 31, 2013, respectively, in research and development expenses, and we intend to continue to make such investments in the foreseeable future.

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

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

Historically, we have generated a majority of our revenue from sales and rentals to customers in the United States. For the three months ended March 31, 2014 and 2013 approximately 18.8% and 20.5%, respectively, of our total revenue was from customers outside the United States, primarily in Europe. To date, all of our revenue has been denominated in United States dollars. We sell our products in 43 countries outside the United States through distributors or directly to large “house” accounts, which include gas companies and home oxygen providers. In this case, we sell to and bill the distributor or “house” accounts directly, leaving responsibility for the patient billing, support and clinical setup to the local provider.

Our total revenue increased $7.9 million to $23.6 million for the three months ended March 31, 2014 from $15.7 million for the three months ended March 31, 2013, primarily due to the growth in direct-to-consumer cash sales and business-to-business sales of our Inogen One systems and growth in rental revenue associated with an increase in the number of patients using Medicare or private payors to rent our products, partially offset by declining Medicare reimbursement rates. We generated Adjusted EBITDA of $4.3 million and $2.5 million for the three months ended March 31, 2014 and 2013, respectively. We generated net income before deemed dividend of $0.9 million and $0.7 million for the three months ended March 31, 2014 and March 31, 2013, respectively. As of March 31, 2014, our accumulated deficit was $62.6 million. The vast majority of our revenue consists of sales revenue and rental revenue.

Basis of presentation

The following describes the line items set forth in our Statements of Operations.

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 rentals from period-to-period. We expect rental revenue should constitute a larger percentage of total revenue, which would increase our gross margins. In addition, we expect both the average selling price and the manufacturing cost of our products to decrease following the introduction of future generations of our Inogen One systems. Inogen One system selling prices and gross margins may fluctuate as we introduce new products and reduce our product costs. For example, the gross margin for our Inogen One G3 is higher than our Inogen One G2. Thus, to the extent our sales of our Inogen One G3 systems are higher than sales of our Inogen One G2 systems, our overall gross margins should improve and, conversely, to the extent our sales of our Inogen One G2 systems are higher than sales of our Inogen One G3 systems, our overall gross margins should decline.

Sales revenue.

Our sales revenue is derived from the sale of our Inogen One systems and related accessories to patients in the United States and to home healthcare providers, distributors and resellers worldwide. Sales revenue is classified into two areas: business-to-business sales and direct-to-consumer sales. For the three months ended March 31, 2014 and March 31, 2013, business-to-business sales as a percentage of sales revenue were 53.1% and 58.9%, respectively. Generally, our direct-to-consumer sales have higher margins than our business-to-business sales. We sold approximately 6,300 Inogen One systems in the first three months of 2014 compared to approximately 3,600 for the same period in 2013 across all sales channels. Management focuses on system sales as an indicator of current business success.

Our sales of used rental equipment revenue is included in sales revenue, and is derived from the sale of our Inogen One systems and related accessories to home healthcare providers and patients when the product has previously been sold or rented to another patient or business.

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

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

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

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

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

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

Rental revenue.

Our rental revenue is derived from the rental of our Inogen One 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. On average, our product rentals have higher gross margins than our product sales.

As of March 31, 2014, we had over 23,000 oxygen rental patients, an increase from approximately 15,400 oxygen rental patients as of March 31, 2013.

Cost of revenue

We manufacture our Inogen One product line in our Goleta, California and Richardson, Texas facilities. Our manufacturing process includes final assembly, testing, and packaging to customer specifications. 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 and delivery costs for items sold. Cost of rental revenue consists primarily of depreciation expense and service costs for rental assets, including material, labor, freight, consumable disposables and logistics costs. We provide a three-year or lifetime warranty on Inogen One systems sold, and we establish a reserve for warranty repairs based on historical warranty repair costs incurred. Provisions for warranty obligations, which are included in cost of sales revenue, are provided for at the time of shipment. We expect the average unit costs of our Inogen One systems to decline in future periods as a result of our ongoing efforts to develop lower-cost Inogen One systems and to improve our manufacturing processes, reduced rental service costs and expected increases in production volume and yields.

As a result of bringing manufacturing and assembly largely in-house and our commitment to driving efficient manufacturing processes, we have reduced our overall system cost by 40% since 2009. We intend to continue to seek ways to reduce our cost of revenue through manufacturing and design improvements.

Operating expenses

Research and development

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

Sales and marketing

Our sales and marketing expenses primarily support our direct-to-consumer strategy. Our sales and marketing expenses consist primarily of personnel-related expenses, including salaries, commissions, benefits, and stock-based compensation, for employees, and allocated facilities costs. They also include expenses for media and advertising, informational kits, public relations and other promotional and marketing activities, including travel and entertainment expenses, as well as customer service and clinical services. Sales and marketing expenses increased throughout 2013 primarily due to an increase in the sales force and the increasing number of rental patients and we expect a further increase in 2014 as we continue to increase sales and marketing activities.

General and administrative

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

Other income (expense), net

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

Results of operations

Comparison of three months ended March 31, 2014 and March 31, 2013

Revenue

	Three months ended March 31,		Change 2014 vs. 2013	
	2014	2013	$	%
Revenue:				
Sales revenue	$14,857	$8,895	$5,962	67.0%
Rental revenue	8,776	6,852	1,924	