Penumbra Inc
Form 10-Q
November 12, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2015

OR

o 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: 001-37557

Penumbra, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	05-0605598
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

One Penumbra Place
1351 Harbor Bay Parkway
Alameda, CA 94502
(Address of principal executive offices and zip code)

(510) 748-3200
(Registrant's Telephone Number, Including Area Code)

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

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: o

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

Large Accelerated Filer o	Accelerated Filer o
Non-accelerated filer x (Do not check if a smaller reporting Company)	Smaller Reporting Company o

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

As of October 31, 2015, the registrant had 29,889,955 shares of common stock, par value $0.001 per share, outstanding.

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PART I - FINANCIAL INFORMATION
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.
Penumbra, Inc.
Condensed Consolidated Balance Sheets
(unaudited)
(in thousands, except share and per share amounts)

	September 30, 2015	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$159,098	$3,290
Marketable investments	—	48,253
Accounts receivable, net of doubtful accounts of $494 and $602	26,055	18,912
Inventories	50,324	33,451
Deferred taxes	7,333	6,280
Prepaid expenses and other current assets	6,267	5,115
Total current assets	249,077	115,301
Property and equipment, net	8,646	5,181
Deferred taxes	1,309	571
Other non-current assets	293	328
Total assets	$259,325	$121,381
Liabilities, Convertible Preferred Stock and Stockholders' Equity (Deficit)		
Current Liabilities:		
Accounts payable	$4,024	$2,348
Accrued liabilities	24,253	18,475
Total current liabilities	28,277	20,823
Other non-current liabilities	2,458	1,461
Total liabilities	30,735	22,284
Commitments and contingencies (Note 8)		
Convertible preferred stock, $0.001 par value per share—none authorized, issued and outstanding at September 30, 2015; 25,000,000 shares authorized, 19,510,410 shares issued and outstanding at December 31, 2014; aggregate liquidation value $149,361 at December 31, 2014	—	111,467
Stockholders' Equity (Deficit):		
Preferred stock, $0.001 par value per share—5,000,000 shares authorized, none issued and outstanding at September 30, 2015; None authorized, issued and outstanding at December 31, 2014	—	—
Common stock, $0.001 par value per share—300,000,000 shares authorized, 29,882,621 issued and outstanding at September 30, 2015; 40,000,000 shares authorized, 4,736,689 issued and outstanding at December 31, 2014	30	5
Additional paid-in capital	249,230	8,446
Notes receivable from stockholders	(26)	(117)
Accumulated other comprehensive loss	(1,536)	(864)
Accumulated deficit	(19,108)	(19,840)
Total stockholders' equity (deficit)	228,590	(12,370)
Total liabilities, convertible preferred stock and stockholders' equity (deficit)	$259,325	$121,381

See accompanying notes to the unaudited condensed consolidated financial statements

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Penumbra, Inc.
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)
(unaudited)
(in thousands, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue	$50,416	$32,464	$131,679	$90,107
Cost of revenue	16,919	11,667	44,079	31,156
Gross profit	33,497	20,797	87,600	58,951
Operating expenses:				
Research and development	4,560	3,897	12,543	11,435
Sales, general and administrative	26,755	16,589	72,698	44,829
Total operating expenses	31,315	20,486	85,241	56,264
Income from operations	2,182	311	2,359	2,687
Interest income (expense), net	17	144	402	183
Other income (expense), net	(115)	(56)	(613)	(148)
Income before provision for income taxes	2,084	399	2,148	2,722
Provision for income taxes	1,183	227	1,416	893
Net income	901	172	732	1,829
Foreign currency translation adjustments, net of tax	(303)	(413)	(892)	(507)
Unrealized gains (losses) on available-for-sale securities, net of tax	—	(266)	220	(92)
Comprehensive income (loss)	$598	$(507)	$60	$1,230
Net income (loss) attributable to common stockholders (Note 16)	$276	$(1,192)	$175	$(933)
Net income (loss) per share attributable to common stockholders —Basic	$0.04	$(0.25)	$0.03	$(0.20)
—Diluted	$0.03	$(0.25)	$0.02	$(0.20)
Weighted average shares used to compute net income (loss) per share attributable to common stockholders —Basic	7,853,730	4,688,045	5,962,031	4,577,725
—Diluted	10,189,248	4,688,045	8,494,651	4,577,725

See accompanying notes to the unaudited condensed consolidated financial statements

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Penumbra, Inc.
Condensed Consolidated Statement of Convertible Preferred Stock and Stockholders’ Equity (Deficit)
(unaudited)
(in thousands, except share amounts)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Notes Receivable from Stockholders	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders’ Equity (Deficit)
	Shares	Amount	Shares	Amount					
Balance at December 31, 2014	19,510,410	$111,467	4,736,689	$5	$8,446	$(117)	$(864)	$(19,840)	$(12,370)
Conversion of convertible preferred stock into common stock upon closing of IPO	(19,510,410)	(111,467)	19,510,410	19	111,448	—	—	—	111,467
Shares issued upon closing of IPO	—	—	4,600,000	5	124,762	—	—	—	124,767
Issuance of common stock	—	—	1,059,172	1	1,058	—	—	—	1,059
Shares held for tax withholdings	—	—	—	—	(2,525)	—	—	—	(2,525)
Repurchase of common stock	—	—	(23,650)	—	(342)	—	—	—	(342)
Stock-based compensation	—	—	—	—	5,126	—	—	—	5,126
Excess tax benefit from stock-based compensation	—	—	—	—	1,257	—	—	—	1,257
Forgiven notes receivable from stockholders	—	—	—	—	—	91	—	—	91
Foreign currency translation adjustment, net of tax of $116	—	—	—	—	—	—	(892)	—	(892)
Unrealized gain on investments, net of tax of $159	—	—	—	—	—	—	220	—	220
Net income	—	—	—	—	—	—	—	732	732
	—	$—	29,882,621	$30	$249,230	$(26)	$(1,536)	$(19,108)	$228,590

Balance at
September 30,
2015
See accompanying notes to the unaudited condensed consolidated financial statements

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Penumbra, Inc.
Condensed Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	Nine Months Ended September 30,	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$732	$1,829
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,227	520
Stock-based compensation	5,126	1,074
Excess tax benefit from stock-based compensation	(1,257)	—
Provision for doubtful accounts	(108)	172
Inventory write downs	704	1,398
Write off of note receivable	91	—
Provision for sales returns	675	122
Loss on minority investment	—	150
Loss on disposal of property and equipment	12	30
Realized loss on marketable investments	541	—
Provision for product warranty	299	26
Changes in operating assets and liabilities:		
Accounts receivable	(7,383)	(4,971)
Inventories	(18,012)	(5,157)
Prepaid expenses and other current and non-current assets	(1,706)	(207)
Accounts payable	1,501	888
Accrued expenses and other non-current liabilities	4,927	3,133
Net cash used in operating activities	(12,631)	(993)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of marketable investments	(4,069)	(48,771)
Proceeds from sales of marketable investments	52,160	12,737
Purchases of property and equipment	(4,507)	(1,798)
Net cash provided by (used in) investing activities	43,584	(37,832)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of preferred stock, net of issuance costs	—	57,212
Proceeds from issuance of common stock issued in initial public offering, net of issuance costs	125,916	—
Proceeds from exercises of stock options	546	923
Excess tax benefit from stock-based compensation	1,257	—
Repurchase of preferred stock	—	(8,311)
Repayment of credit facility	—	(6,000)
Repurchase of common stock and stock options	—	(1,022)
Payment of employee taxes related to vested common and restricted stock	(2,525)	—
Net cash provided by financing activities	125,194	42,802
Effect of foreign exchange rate changes on cash and cash equivalents	(339)	80
Net Increase In Cash And Cash Equivalents	155,808	4,057
CASH AND CASH EQUIVALENTS—Beginning of period	3,290	4,131
CASH AND CASH EQUIVALENTS—End of period	$159,098	$8,188
NONCASH INVESTING AND FINANCING ACTIVITIES:		

Conversion of convertible preferred stock into common stock	$111,467	$—
Purchase of property and equipment funded through accounts payable	$200	$85
Deferred issuance costs not yet paid	$1,149	$—

See accompanying notes to the unaudited condensed consolidated financial statements

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Penumbra, Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. Organization and Description of Business

Penumbra, Inc. (the "Company") is a global interventional therapies company that designs, develops, manufactures and markets innovative medical devices. The Company has a broad portfolio of products that addresses challenging medical conditions and significant clinical needs across two major markets, neuro and peripheral vascular. The conditions that the Company's products address include, among others, ischemic stroke, hemorrhagic stroke and various peripheral vascular conditions that can be treated through thrombectomy and embolization procedures.

2. Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The accompanying interim condensed consolidated balance sheet as of September 30, 2015, the interim condensed consolidated statements of operations for the three and nine months ended September 30, 2015 and 2014, the interim condensed consolidated statement of preferred stock and stockholders' equity (deficit) for the nine months ended September 30, 2015, and the interim condensed consolidated statements of cash flows for the nine months ended September 30, 2015 and 2014 are unaudited. The unaudited interim condensed consolidated financial statements included herein have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial information. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. The December 31, 2014 condensed consolidated balance sheet was derived from the audited financial statements as of that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, reflect all adjustments of a normal recurring nature considered necessary to state fairly the Company's financial position as of September 30, 2015 and results of its operations for the three and nine months ended September 30, 2015 and 2014, and the cash flows for the nine months ended September 30, 2015 and 2014. The interim results for the nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or for any other future annual or interim period.

The information included in this quarterly report on Form 10-Q should be read in conjunction with the financial statements and notes thereto contained in the Company's Prospectus dated September 17, 2015 as filed by the Company with the SEC pursuant to Rule 424(b)(4) under the Securities Act of 1933, as amended, relating to the Company's Registration Statement on Form S-1 ("Prospectus") (File No. 333-206412).

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity accounts; disclosure of contingent assets and liabilities at the date of the financial statements; and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, including those related to provisions for doubtful accounts, sales return reserve, warranty reserves, valuation of inventories, useful lives of property and equipment, income taxes, the valuation of equity instruments and contingencies, among others. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other data. Actual results could differ from those estimates.

Segments

The Company determined its operating segment on the same basis that it uses to evaluate its performance internally. The Company has one business activity: the design, development, manufacturing and marketing of innovative medical devices, and operates as one operating segment. The Company's chief operating decision-maker, its Chief Executive

Officer, reviews its operating results for the purpose of allocating resources and evaluating financial performance. The Company determines revenue by geographic area, based on the destination to which it ships its products.

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Penumbra, Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

Foreign Currency Translation
The Company's condensed consolidated financial statements are prepared in United States Dollars (USD). Its foreign subsidiaries use their local currency as their functional currency and maintain their records in the local currency. Accordingly, the assets and liabilities of these subsidiaries are translated into USD using the current exchange rates in effect at the balance sheet date and equity accounts are translated into USD using historical rates. Revenues and expenses are translated using the average exchange rates in effect. The resulting foreign currency translation adjustments are recorded in other comprehensive income in the condensed consolidated balance sheets. Transactions denominated in foreign currency are translated at exchange rates at the date of transaction with foreign currency gains (losses) recorded in other income (expense), net in the condensed consolidated statements of operations and other comprehensive income. The Company recognized net foreign currency transaction gains of $0.1 million and $0.1 million during the three months ended September 30, 2015 and 2014, respectively, and $11,000 and $0.2 million during the nine months ended September 30, 2015 and 2014, respectively.
As the Company's international operations grow, its risks associated with fluctuation in currency rates will become greater, and the Company will continue to reassess its approach to managing this risk. In addition, currency fluctuations or a weakening USD can increase the costs of the Company's international expansion. To date, the Company has not entered into any foreign currency hedging contracts, since exchange rate fluctuations have not had a material impact on its operating results and cash flows.
Concentration of Credit Risk
Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash and cash equivalents, marketable investments and accounts receivable. The majority of the Company's cash is held by one financial institution in the United States in excess of federally insured limits. The Company maintained investments in money market funds that were not federally insured during the year ended December 31, 2014 and held cash in foreign banks of approximately $2.3 million and $0.8 million at September 30, 2015 and December 31, 2014, respectively, that was not federally insured. The Company has not experienced any losses on its deposits of cash and cash equivalents.
All of the Company's revenue has been derived from sales of its products in the United States and international markets. The Company uses both its own salesforce and independent distributors to sell its products. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of entities comprising the Company's customer base. The Company performs ongoing credit evaluations of its customers, including its distributors, does not require collateral, and maintains allowances for potential credit losses on customer accounts when deemed necessary.
One customer (a distributor) accounted for 11% and 11%, respectively, of the Company's revenue during the three months ended September 30, 2015 and 2014. The same customer accounted for 11% and 12%, respectively, of the Company's revenue during the nine months ended September 30, 2015 and 2014. No customer accounted for greater than 10% of the Company's accounts receivable balance as of September 30, 2015 or December 31, 2014.
Significant Risks and Uncertainties
The Company is subject to risks common to medical device companies including, but not limited to, new technological innovations, dependence on key personnel, protection of proprietary technology, compliance with government regulations, product liability, uncertainty of market acceptance of products and the potential need to obtain additional financing. The Company is dependent on third party suppliers, in some cases single-source suppliers. There can be no assurance that the Company's products will continue to be accepted in the marketplace, nor can there be any assurance that any future products can be developed or manufactured at an acceptable cost and with appropriate performance characteristics, or that such products will be successfully marketed, if at all.
The Company's products require approval or clearance from the U.S. Food and Drug Administration prior to commencing commercial sales in the United States. There can be no assurance that the Company's products will receive all of the required approvals or clearances. Approvals or clearances are also required in foreign jurisdictions in

which the Company sells its products. If the Company is denied such approvals or clearances or such approvals or clearances are delayed, it may have a material adverse impact on the Company’s results of operations, financial position and liquidity.

Fair Value of Financial Instruments
Carrying amounts of certain of the Company's financial instruments, including cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities.
Cash, Cash Equivalents and Marketable Investments
The Company invests its cash primarily in money market funds and in highly liquid debt instruments of U.S. federal and municipal governments and their agencies and corporate debt securities. All highly liquid investments with stated maturities of three months or less from the date of purchase are classified as cash equivalents; all highly liquid investments with stated maturities of greater than three months are classified as marketable investments. The majority of the Company's cash and investments are held in U.S. banks.
The Company determines the appropriate classification of its investments in marketable investments at the time of purchase and re-evaluates such designation at each balance sheet date. The Company's marketable investments have been classified and accounted for as available-for-sale. Investments with remaining maturities of more than one year are viewed by the Company as available to support current operations and are classified as current assets under the caption marketable investments in the accompanying condensed consolidated balance sheets. Investments in marketable investments are carried at fair value, with the unrealized gains and losses reported as a component of accumulated other comprehensive loss. Any realized gains or losses on the sale of marketable investments are determined on a specific identification method, and such gains and losses are reflected as a component of other income (expense), net.
Impairment of Marketable Investments
After determining the fair value of available-for-sale debt instruments, gains or losses on these securities are recorded to accumulated other comprehensive income (loss) until either the security is sold or the Company determines that the decline in value is other-than-temporary. The primary differentiating factors that the Company considers in classifying impairments as either temporary or other-than-temporary impairments is the intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value, the length of the time and the extent to which the market value of the investment has been less than cost, the financial condition and near-term prospects of the issuer. There were no other-than-temporary impairments for the three or nine months ended September 30, 2015 and 2014. The Company did not have any marketable investments as of September 30, 2015.
Accounts Receivable
Accounts receivable are stated at invoice value less estimated allowances for doubtful accounts. The Company continually monitors customer payments and maintains a reserve for estimated losses resulting from its customers' inability to make required payments. The Company considers factors such as historical experience, credit quality, age of the accounts receivable balances, geographic related risks and economic conditions that may affect a customer's ability to pay. In cases where there are circumstances that may impair a specific customer's ability to meet its financial obligations, a specific allowance is recorded against amounts due, and thereby reduces the net recognized receivable to the amount reasonably believed to be collectible.
Inventories
Inventories are stated at the lower of cost (determined under the first-in first-out method) or market. Write downs are provided for raw materials, components or finished goods that are determined to be excessive or obsolete. Market value is determined as the lower of replacement cost or net realizable value. The Company regularly reviews inventory quantities in consideration of actual loss experience, projected future demand and remaining shelf life to record a provision for excess and obsolete inventory when appropriate.
The estimate of excess quantities is subjective and primarily dependent on the Company's estimates of future demand for a particular product or components or raw materials used in the manufacturing of such product. If the estimate of future demand is inaccurate based on actual sales, the Company may increase the write down for excess inventory and record a charge to inventory impairment in the accompanying condensed consolidated statements of operations and

comprehensive income. The Company periodically evaluates the carrying value of inventory on hand for potential excess amounts over demand using the same lower of cost or market approach that has been used to value the inventory. The Company also periodically evaluates inventory quantities in consideration of actual loss experience. As a result of these evaluations, the Company recognized total

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write downs of $0.4 million and $0.9 million for the three months ended September 30, 2015 and 2014, respectively, and $0.7 million and $1.4 million for the nine months ended September 30, 2015 and 2014, respectively.

Property and Equipment, net

Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over five years, which is the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life. Upon retirement or sale, the cost and the related accumulated depreciation are removed from the condensed consolidated balance sheet and the resulting gain or loss is reflected in operations. Maintenance and repairs are charged to operations as incurred.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When such an event occurs, management determines whether there has been impairment by comparing the anticipated undiscounted future net cash flows to the related asset group's carrying value. If an asset is considered impaired, the asset is written down to fair value, which is determined based either on discounted cash flows or appraised value, depending on the nature of the asset. There was no impairment of long-lived assets during the three or nine months ended September 30, 2015 and 2014.

Convertible Preferred Stock

The Company, prior to the closing of its initial public offering ("IPO") on September 23, 2015, classified its outstanding convertible preferred stock as temporary equity in the condensed consolidated balance sheet due to the existence of certain change in control events that were not solely within the Company's control, including liquidation, sale or transfer of the Company, that could trigger the ability of the holders of the convertible preferred stock to call for redemption of shares. Upon the closing of the IPO, all outstanding shares of convertible preferred stock automatically converted into shares of common stock on a one-for-one basis.

Revenue Recognition

Revenue is comprised of product revenue net of returns, discounts, administration fees and sales rebates. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is reasonably assured. Evidence of an arrangement consists of customer orders and the Company typically considers delivery to have occurred once title and risk of loss has been transferred and the product has been delivered to the customer. The Company typically recognizes revenue when products are delivered to hospital customers or distributors. However, with respect to products that the Company consigns to hospitals, which primarily consist of coils, the Company recognizes revenue at the time hospitals utilize products in a procedure.

Deferred revenue represents amounts that the Company has already invoiced its customers and are ultimately expected to be recognized as revenue, but for which not all revenue recognition criteria have been met. The Company had a deferred revenue balance of $0.8 million and $1.6 million, as of September 30, 2015 and December 31, 2014, respectively.

The Company's terms and conditions permit product returns and exchanges, and it records returns reserves in the period when revenue is recognized. Estimates are based on actual historical returns over the prior three years and are recorded as reductions in revenue at the time of sale. Upon recognition, the Company reduces revenue and cost of revenue for the estimated return. Return rates can fluctuate over time, but are sufficiently predictable to allow the Company to estimate expected future product returns.

Cost of Revenue

Cost of revenue includes direct and indirect costs associated with the manufacture of the Company's products. Direct costs include material and labor, while indirect costs include inbound freight charges, receiving costs, inspection and testing costs, warehousing costs, royalty expense and other labor and overhead costs incurred in the manufacturing of products. Cost of revenue also includes stock-based compensation, warranty replacement costs, cost of revenue related to product return reserves and excess and obsolete inventory write-downs.

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Shipping Costs

Shipping and handling costs charged to customers are recorded as revenue. Shipping and handling costs are included in cost of revenue.

Research and Development (R&D) Expenses

R&D costs primarily consist of product development, clinical and regulatory expenses, materials, depreciation and other costs associated with the development of the Company's products. R&D costs also include related personnel and consultants' salaries, benefits and related costs, including stock-based compensation. The Company expenses R&D costs as they are incurred.

The Company's clinical trial accruals are based on estimates of patient enrollment and related costs at clinical investigator sites. The Company estimates preclinical and clinical trial expenses based on the services performed pursuant to contracts with research institutions and clinical research organizations that conduct and manage preclinical studies and clinical trials on its behalf. In accruing service fees, the Company estimates the time period over which services will be performed and the level of patient enrollment and activity expended in each period. If the actual timing of the performance of services or the level of effort varies from the estimate, the Company will adjust the accrual accordingly. Payments made to third parties under these arrangements in advance of the receipt of the related services are recorded as prepaid expenses until the services are rendered.

Advertising Costs

Advertising costs are included in selling, general and administrative expenses and are expensed as incurred. Advertising costs consist primarily of trade show and booth costs, product demonstration, and marketing materials. Advertising costs were $0.1 million and $0.1 million for the three months ended September 30, 2015 and 2014, respectively, and were $0.4 million and $0.2 million for the nine months ended September 30, 2015 and 2014, respectively.

Stock-Based Compensation

The Company recognizes the cost of stock-based compensation in the financial statements based upon fair value. The fair value of restricted stock awards is determined based on the number of units granted and the closing price of the Company's common stock as of the grant date. The fair value of stock options is determined as of the grant date using the Black-Scholes option pricing model. The Company's determination of the fair value of stock options is impacted by its common stock price as well as changes in assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected term that options will remain outstanding, expected common stock price volatility over the term of the option awards, risk-free interest rates and expected dividends.

The fair value is recognized over the period during which an optionee is required to provide services in exchange for the option award, known as the requisite service period (usually the vesting period) on a straight-line basis.

Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. The Company estimates future forfeitures at the date of grant and revises the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. To the extent actual forfeiture results differ from the estimates, the difference is recorded as a cumulative adjustment in the period forfeiture estimates are revised. No compensation cost is recorded for options that do not vest.

Equity instruments issued to non-employees are recorded at their fair value on the measurement date and are subject to periodic adjustments as the underlying equity instruments vest. The fair value of these equity instruments are expensed over the service period.

Estimating the fair value of equity-settled awards as of the grant date using valuation models, such as the Black-Scholes option pricing model, is affected by assumptions regarding a number of complex variables. Changes in the assumptions can materially affect the fair value and ultimately how much stock-based compensation expense is recognized. These inputs are subjective and generally require significant analysis and judgment to develop. For all stock options granted to date, the Company estimated the volatility data based on a study of publicly traded industry peer companies. For purposes of identifying these peer companies, the Company considered the industry, stage of development, size and financial leverage of potential comparable companies. The risk-free interest rate is based on the yield available on U.S. Treasury zero-coupon issues similar in duration to the expected term of the equity-settled award. The Company uses the Staff Accounting Bulletin, or SAB, 110, simplified method to calculate the expected term, which is the average of the contractual term and vesting period.

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Penumbra, Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

Income Taxes
The Company accounts for income taxes using the asset and liability method, whereby deferred tax asset and liability account balances are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance to reduce the net deferred tax assets to their estimated realizable value.
The calculation of the Company’s current provision for income taxes involves the use of estimates, assumptions and judgments while taking into account current tax laws, interpretation of current tax laws and possible outcomes of future tax audits. The Company has established reserves to address potential exposures related to tax positions that could be challenged by tax authorities. Although the Company believes its estimates, assumptions and judgments to be reasonable, any changes in tax law or its interpretation of tax laws and the resolutions of potential tax audits could significantly impact the amounts provided for income taxes in the Company’s consolidated financial statements.
During interim periods, the Company generally utilizes the estimated annual effective tax rate method which involves the use of forecasted information. The discrete method of calculating the estimated effective tax rate, on the other hand, involves the use of actual year-to-date information. For interim periods where the discrete method of calculating the estimated effective tax rate is determined to be a more reliable method than the estimated annual effective tax rate method, the Company will use the more reliable method to estimate its interim period income tax accrual.
The calculation of the Company’s deferred tax asset balance involves the use of estimates, assumptions and judgments while taking into account estimates of the amounts and type of future taxable income. Actual future operating results and the underlying amount and type of income could differ materially from the Company’s estimates, assumptions and judgments thereby impacting the Company’s financial position and results of operations.
The Company follows the guidance relating to accounting for uncertainty in income taxes, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in the Company’s income tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.
The Company includes interest and penalties related to unrecognized tax benefits within income tax expense in the accompanying consolidated statements of operations. The Company has not incurred any interest or penalties related to unrecognized tax benefits in any of the periods presented.
Comprehensive Income
The Company is required to display comprehensive income and its components as part of the Company’s consolidated financial statements. Comprehensive income consists of net income, unrealized gains on available-for-sale investments and the effects of foreign currency translation.
Deferred Offering Costs
Deferred offering costs, which primarily consisted of direct incremental legal and accounting fees were capitalized prior to the closing of the IPO. Upon closing of the IPO, the deferred offering costs were offset against IPO proceeds.
Net Income (Loss) Per Share of Common Stock
The Company, for the periods prior to the closing of the IPO, calculated its basic and diluted net income (loss) per share attributable to common stockholders in conformity with the two-cla