THORATEC CORP
Form POS AM
June 03, 2005

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As filed with the Securities and Exchange Commission on June 3, 2005

Registration No. 333-118274

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Post-Effective
Amendment No. 3 To
FORM S-3
REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

THORATEC CORPORATION
(Exact Name of Registrant as Specified in its Charter)

California	**94-234064**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

6035 Stoneridge Drive
Pleasanton, California 94588
(925) 897-8600
(Address, including Zip Code, and Telephone Number, including Area Code, of Registrant s Principal Executive Offices)

David Lehman
Vice President and General Counsel
Thoratec Corporation
6035 Stoneridge Drive
Pleasanton, California 94588
(925) 897-8600
(Address, including Zip Code, and Telephone Number, including Area Code, of Agent for Service)

Copies to:

Gregory J. Conklin, Esq.
Gibson, Dunn & Crutcher LLP
One Montgomery Street, 31st Floor
San Francisco, California 94104
(415) 393-8200

Approximate Date of Commencement of Proposed Sale to the Public: From time to time after the effective date of this Registration Statement.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. þ

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act of 1933, check the following box and list the Securities Act of 1933 registration statement number of the earlier effective registration statement for the same offering. o_____

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act of 1933, check the following box and list the Securities Act of 1933 registration statement number of the earlier effective registration statement for the same offering. o_____

If delivery of this prospectus is expected to be made pursuant to Rule 434, check the following box. o

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

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Explanatory Note

The purpose of this Post-Effective Amendment No. 3 to the Registration Statement on Form S-3 of Thoratec Corporation (333-118274) is to amend and restate the text and table under the caption Selling Securityholders in the prospectus to add the names and respective holdings of the selling securityholders who have requested inclusion in the prospectus since the effective date of Amendment No. 2 to the Registration Statement. Certain other information included herein has also been updated.

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

SUBJECT TO COMPLETION, DATED JUNE 3, 2005

$247,427,000 Principal Amount at Maturity of
Senior Subordinated Convertible Notes due 2034
and
Shares of Common Stock
Issuable upon Conversion of the Notes

We originally issued these notes in private placement transactions in May 2004. This prospectus will be used by selling securityholders to resell their notes and the common stock issuable upon conversion of the notes.

We issued the notes at an issue price of $580.98 per note (58.098% of the principal amount at maturity). Interest on the notes accruing at the rate of 1.3798% per year on the principal amount at maturity (equivalent to a rate of 2.375% per year of the issue price), is payable semiannually in arrears in cash on May 16 and November 16 of each year, beginning November 16, 2004, until May 16, 2011. After that date, we will not pay cash interest on the notes prior to maturity. Instead, on May 16, 2034, the maturity date of the notes, a holder will receive $1,000 per note. The original issue discount for non-tax purposes will accrue daily at a rate of 2.375% per year beginning on May 16, 2011 on a semiannual bond equivalent basis using a 360-day year comprised of twelve 30-day months. We purchased a portfolio of U.S. government securities that we pledged to secure the first six scheduled interest payments on the notes. Other than this pledge of U.S. government securities, the notes are unsecured, senior subordinated obligations and rank equally with our future senior subordinated indebtedness, if any, will rank junior to our existing and future senior indebtedness, and will effectively rank junior to the existing or future indebtedness of our subsidiaries.

Holders may convert each $1,000 principal amount of their notes into 29.4652 shares of our common stock, subject to adjustment, only if: (1) the sale price of our common stock reaches, or the trading price of the notes falls below, specified thresholds, (2) the notes are called for redemption, or (3) specified corporate transactions or significant distributions to holders of our common stock have occurred. Upon a conversion, we may elect to deliver cash or a combination of cash and common stock in lieu of any common stock deliverable upon conversion.

Holders may require us to purchase for cash all or a portion of their notes on May 16, 2011 at a price of $580.98 per note, on May 16, 2014 at a price of $623.62 per note, on May 16, 2019 at a price of $701.77 per note, on May 16, 2024 at a price of $789.70 per note, and on May 16, 2029 at a price of $888.65 per note, in each case plus accrued but unpaid interest, if any. In addition, if we experience a fundamental change as described in this prospectus, each holder may require us to repurchase all or a portion of its notes, subject to specified exceptions, at a price equal to the sum of the issue price, accrued original issue discount and accrued but unpaid cash interest and liquidated damages, if any, plus in certain circumstances, a make-whole premium. Upon a fundamental change, we may pay the repurchase price in cash or, in certain circumstances, we may choose to pay the repurchase price in shares of our common stock or a combination of cash and shares of our common stock.

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We may redeem for cash all or a portion of the notes at any time on or after May 16, 2011, at a price equal to the sum of the original issue price, the accrued original issue discount and accrued but unpaid cash interest, if any, to the redemption date.

Since their original issuance, the notes and the shares of common stock issuable upon conversion of the notes have been eligible for trading in the Private Offerings, Resales and Trading through Automated Linkages (PORTAL) system of the National Association of Securities Dealers, Inc. However, notes sold by means of this prospectus and the shares of common stock issuable upon conversion thereof will no longer be eligible for trading on the PORTAL Market. We do not intend to list the notes on any other automated quotation system or any securities exchange. Our common stock currently trades on the NASDAQ National Market under the symbol THOR. On June 2, 2005, the last reported sale price of our common stock on the NASDAQ National Market was $14.61 per share.

The selling securityholders will receive all of the net proceeds from sales of the securities and will pay all underwriting discounts and selling commissions, if any. We are responsible for the payment of other expenses incident to the registration of the securities. We will not receive any proceeds from this offering.

Investing in the notes and the common stock issuable upon conversion of the notes involves risks that are described in the Risk Factors section beginning on page 6 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

The date of this prospectus is June __, 2005.

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You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. You should assume that the information appearing in this prospectus and the documents incorporated in this prospectus by reference are accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

References in this prospectus to Thoratec, we, us and our refer to Thoratec Corporation, a company incorporated the State of California, and its direct and indirect subsidiaries, unless the context otherwise requires or otherwise specified in this prospectus.

Thoratec, the Thoratec logo, Thoralon, TLC-II, HeartMate, HeartPak and Vectra are registered trademarks, and Aria is a trademark, of Thoratec Corporation. HEMOCHRON, ProTime, Surgicutt, Tenderlett, tenderfoot and IRMA are registered trademarks of International Technidyne Corporation, or ITC, our wholly-owned subsidiary. Each trademark, trade name or service mark of any other company appearing in this prospectus belongs to its holder.

MARKET AND INDUSTRY DATA

Market data used throughout this prospectus and the documents incorporated by reference herein, including information relating to our relative position in the medical device industry, is based on the good faith estimates of our management, which estimates are based upon their review of internal surveys, independent industry publications and other publicly available information. Although we believe these sources are reliable, we do not guarantee the accuracy or completeness of this information and we have not independently verified this information. Although we are not aware of any misstatements regarding the market and industry data presented in this prospectus, our estimates involve risks and uncertainties and are subject to change based on various factors, including those discussed under the heading Risk Factors.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and the documents incorporated by reference herein include forward-looking statements. For these statements, we claim the protection of the safe harbor for forward looking statements provided by Section 27A of the Securities Act of 1933, as amended, and 21E of the Securities Exchange Act of 1934, as amended. We

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have based these forward-looking statements on our current expectations and projections about future events. Our actual results could differ materially from those discussed in, or implied by, these forward-looking statements. Forward-looking statements are identified by words such as believe, anticipate, expect, intend, plan, may , h other similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Forward-looking statements include, but are not necessarily limited to, those relating to:

- our ability to obtain and maintain regulatory approval of our products for sale in the United States and internationally;
- the results and timing of our clinical trials;
- reimbursement policies and decisions by government agencies and third party payors;
- other competing therapies that may currently, or in the future, be available to heart failure patients;
- our plans to develop and market new products and the rate of market penetration of our new products; and
- our ability to improve our financial performance.

Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described in the Risk Factors section of this prospectus and in the Competition, Patents and Proprietary Technology, Government Regulation, Factors That May Affect Future Results, Results of Operations, Qualitative and Quantitative Disclosures About Market Risk, and Liquidity and Capital Resources sections contained in our Annual Report on Form 10-K for the fiscal year ended January 1, 2005 and our Quarterly Report on Form 10-Q for the quarter ended April 2, 2005 and our other SEC filings, which identify important risks and uncertainties that could cause actual results to differ materially from those contained in the forward-looking statements and in other documents we file with the SEC. We are not obligated to update or revise these forward-looking statements to reflect new events or circumstances.

We urge you to consider these factors carefully in evaluating the forward-looking statements contained in this prospectus. All subsequent written or oral forward-looking statements attributable to our company or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The forward-looking statements included in this prospectus are made only as of the date of this prospectus. We do not intend, and undertake no obligation, to update these forward-looking statements.

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SUMMARY

Overview

We are a leading manufacturer of circulatory support products for use by patients with congestive heart failure, or CHF. Our Ventricular Assist Devices, or VADs, are used primarily by CHF patients to perform some or all of the pumping function of the heart and we currently offer the widest range of products to serve this market. We believe that our long-standing reputation for quality and innovation and our excellent relationships with leading cardiovascular surgeons worldwide position us to capture growth opportunities in the expanding congestive heart failure market. Through our wholly-owned subsidiary, ITC, we design, develop, manufacture and market point-of-care diagnostic test systems and incision products that provide for fast, accurate blood test results to improve patient management, reduce healthcare costs and improve patient outcomes.

Our business is comprised of two segments; Cardiovascular and ITC.

The major product lines within the Cardiovascular segment are:

Circulatory Support Products. Our circulatory support products include VADs for the short-term and long-term treatment of congestive heart failure.

Vascular Graft Products. We have developed small diameter grafts using our proprietary materials to address the vascular access market. Our grafts are sold in the United States and internationally for use in hemodialysis.

The major product lines of our ITC segment are:

Point-of-Care Diagnostics. Our point-of-care products include coagulation diagnostic test systems that monitor a patient while being administered certain anticoagulants, blood gas/electrolyte and chemistry status, or anemia.

Incision. Our incision products include devices used to obtain a patient s blood sample for diagnostic testing and screening for platelet function.

We currently market VADs that may be implanted or worn outside the body and that are suitable for treatments for different durations for patients of varying sizes and ages. We estimate that doctors have implanted over 9,500 of our devices in patients suffering from heart failure. Our devices are currently used primarily for patients awaiting a heart transplant or Destination Therapy implants. On November 6, 2002, the United States Food and Drug Administration, or FDA, approved the HeartMate VAD as the first heart assist device for Destination Therapy, or permanent support for patients suffering from end-stage heart failure who are not eligible for heart transplantation. On April 7, 2003, the FDA approved the HeartMate XVE, an enhanced version of the HeartMate VAD, for Destination Therapy. Thoratec is the only company to have a ventricular assist device approved for Destination Therapy in the United States. In August 2004, we received FDA approval in the U.S. to market the Thoratec Implantable Ventricular Assist Device, or IVAD, for use in bridge-to-transplantation and post-cardiotomy recovery patients who are unable to be weaned from cardiopulmonary bypass. This makes the IVAD the only currently approved implantable cardiac assist device that can provide left, right or biventricular support.

Corporate Information

We were incorporated in California in March 1976. On February 14, 2001, we changed our name from Thoratec Laboratories Corporation to Thoratec Corporation. Our executive offices are located at 6035 Stoneridge Drive, Pleasanton, California 94588, and our telephone number is (925) 847-8600. Our website address is

http://www.thoratec.com. The information found on our website and on websites linked from it are not incorporated into or otherwise made a part of this prospectus.

The Offering

The following is a brief summary of certain terms of this offering. For a more complete description of the

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terms of the notes, see Description of Notes in this prospectus.

Issuer	Thoratec Corporation, a California corporation.
Notes offered	$247,427,000 aggregate principal amount at maturity of senior subordinated convertible notes due 2034. Each note will have a principal amount at maturity of $1,000 and was issued at a price of $580.98 per note (58.098% of the principal amount at maturity).
Maturity	May 16, 2034.
Cash interest	1.3798% per year on the principal amount at maturity (equivalent to a rate of 2.375% per year on the issue price), payable semiannually in arrears in cash on May 16 and November 16 of each year, beginning November 16, 2004 until May 16, 2011.
Original issue discount	We issued the notes at an issue price significantly below the principal amount at maturity of the notes. As a result, the original issue discount, for non-tax purposes, will accrue daily at a rate of 2.375% per year beginning on May 16, 2011, calculated on a semiannual bond equivalent basis using a 360-day year comprised of twelve 30-day months.
Security	We purchased and pledged to the trustee under the indenture for the exclusive benefit of the holders of the notes approximately $9.8 million of U.S. government securities, which we expect will be sufficient, upon receipt of scheduled principal and interest payments thereon, to provide for payment in full of the first six scheduled interest payments, but not liquidated damages, if any, on the notes when due. The notes will not otherwise be secured.
Conversion rights	If the conditions for conversion are satisfied, for each $1,000 principal amount at maturity of notes surrendered for conversion you will receive 29.4652 shares of our common stock, which we refer to in this prospectus as the conversion rate. In lieu of delivering shares of our common stock upon notice of conversion of all or any portion of the notes, we may elect to pay holders surrendering notes an amount in cash per note (or a portion of a note) equal to the average sale price of our common stock for the five consecutive trading days immediately following (a) the date of our notice of our election to deliver cash if we have not given notice of redemption or (b) the conversion date, in the case of conversion following our notice of redemption specifying that we intend to deliver cash upon conversion, in either case multiplied by the conversion rate in effect on that date. If an event of default (other than a default in a cash payment upon conversion of the notes) has occurred and is continuing, we may not pay cash upon conversion of

any notes or portion of the notes (other than cash for fractional shares). A holder of a note otherwise entitled to a fractional share will receive cash equal to the applicable portion of the closing price of our common stock on the trading day immediately preceding the conversion date.

The conversion rate may be adjusted for certain reasons, but will not be adjusted for accrued original issue discount or accrued but unpaid cash interest. Upon conversion, a holder will not receive any cash payment representing accrued but unpaid cash interest. Instead, accrued but unpaid cash interest will be deemed paid upon payment of the conversion price in

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	cash or a combination of cash and common stock. At any time after September 30, 2004, holders may surrender notes for conversion, if, as of the last day of the preceding calendar quarter, the closing sale price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of common stock on the last day of such preceding calendar quarter for any one quarter. If the foregoing condition is satisfied, then the notes will thereafter be convertible at any time at the option of the holder, through maturity. The accreted conversion price per share as of any day will equal the sum of the issue price of the note plus the accrued original issue discount to that day, divided by the then applicable conversion rate. Holders may surrender notes for conversion at any time on or prior to May 16, 2029 during the five business day period after any five consecutive trading day period in which the trading price per note for each day of that period was less than 98% of the product of the closing sale price of our common stock and the conversion rate on each such day; provided that if on the day prior to any conversion pursuant to this trading price condition the closing sale price of our common stock is greater than the accreted conversion price but less than or equal to 120% of the accreted conversion price, then holders will receive upon conversion, in lieu of shares of common stock based on the conversion rate, cash or common stock or a combination of cash and common stock at our option with a value equal to the accreted principal amount of the notes plus accrued and unpaid cash interest and liquidated damages, if any, as of the conversion date. Notes or portions of notes in integral multiples of $1,000 principal amount at maturity called for redemption may be surrendered for conversion until the close of business on the second business day prior to the redemption date. In addition, if we make a significant distribution to our shareholders or if we are a party to certain consolidations, mergers or share exchanges, notes may be surrendered for conversion, as provided in Description of Notes Conversion Rights.
Redemption of notes at our option	We may redeem, for cash, all or a portion of the notes at any time on or after May 16, 2011, at a price equal to the sum of the issue price and the accrued original issue discount, plus accrued and unpaid cash interest, if any, to the redemption date. See Description of Notes Redemption of Notes at Our Option.
Purchase of the notes by Thoratec at the option of the holder	Holders may require us to purchase all or a portion of their notes on each of the following dates at the following prices, plus accrued but unpaid cash interest, if any, to the purchase date:

On May 16, 2011 at a price of $580.98 per note;

On May 16, 2014 at a price of $623.62 per note;

On May 16, 2019 at a price of $701.77 per note;

On May 16, 2024 at a price of $789.70 per note; and

On May 16, 2029 at a price of $888.65 per note.

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	We may only pay the purchase price in cash and not in common stock.
Fundamental Change	If we undergo a fundamental change (as described in this prospectus), except in certain circumstances, you will have the option to require us to repurchase all or any portion of your notes. The fundamental change repurchase price will be the sum of the issue price and accrued original issue discount plus accrued but unpaid cash interest and liquidated damages, if any, plus, in certain circumstances, a make-whole premium. Upon a fundamental change we may pay the repurchase price in cash or, in certain circumstances, we may choose to pay the repurchase price in shares of our common stock or a combination of cash and shares of our common stock.
Ranking	The notes:

are our general senior subordinated unsecured obligations (except as set forth in Description of Notes Security);

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	does not become effective within the specified time periods. See Description of Notes Registration Rights.
Guarantees	None.
Sinking fund	None.
DTC eligibility	The notes were issued in fully registered book-entry form and are represented by one or more permanent global notes without coupons. Global notes were deposited with a custodian for and registered in the name of a nominee of The Depository Trust Company (DTC) in New York, New York. Beneficial interests in global notes will be shown on, and transfers thereof will be effected only through, records maintained by DTC and its direct and indirect participants, and your interest in any global note may not be exchanged for certificated notes, except in the limited circumstances described herein. See Description of Notes Global Notes; Book Entry; Form.
Trading	Since their initial issuance, the notes have been eligible for trading in the PORTAL Market of the National Association of Securities Dealers, Inc. However, notes sold by means of this prospectus will no longer be eligible for trading on the PORTAL Market. We do not intend to list the notes on any other automated quotation system or any securities exchange. Furthermore, we can provide no assurances as to the liquidity of, or trading market for, the notes.
NASDAQ symbol for our common stock	Our common stock is listed on the NASDAQ National Market under the symbol THOR.
Risk factors	See Risk Factors beginning on page 6 of this prospectus and other information included in, or incorporated by reference into, this prospectus for a discussion of factors you should consider carefully before deciding to invest in the notes.

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RISK FACTORS

Our business faces many risks. The risks described below are what we believe to be the material risks facing our company and holders of the notes. However, the risks described below may not be the only risks we face. Additional risks that we do not yet know of or that we currently believe are immaterial may also impair our business operations. If any of the events or circumstances described in the following risk factors actually occurs, our business, financial condition or results of operations could suffer, and the trading price of our common stock or the notes offered hereby could decline significantly. You should consider the following risks, as well as the other information included in and incorporated by reference into this prospectus before deciding to invest in the notes.

Risks Related to Our Business

We have a history of net losses.

We were founded in 1976 and we have a history of incurring losses from operations. We anticipate that our expenses will increase as a result of increased pre-clinical and clinical testing, research and development and selling, general and administrative expenses. We could also incur significant additional costs in connection with our business development activities and the development and marketing of new products and indicated uses for our existing products as well as litigation and equity based compensation costs. Such costs could prevent us from achieving or maintaining profitability in future periods.

Since our physician and hospital customers depend on third party reimbursement, if third party payors fail to provide appropriate levels of reimbursement for our products, our results of operations will be harmed.

Significant uncertainty exists as to the reimbursement status of newly approved health care products such as VADs and vascular grafts, which uncertainty can delay or prevent adoption in volume by hospitals. Government and other third party payors are increasingly attempting to contain health care costs. Payors are attempting to contain costs by, for example, limiting coverage and the level of reimbursement of new therapeutic products. Payors are also attempting to contain costs by refusing, in some cases, to provide any coverage for uses of approved products for disease indications other than those for which the FDA has granted marketing approval.

To date, a majority of private insurers with whom we have been involved and the Centers for Medicare & Medicaid Services, or the CMS, have determined to reimburse some portion of the cost of our VADs and our diagnostic and vascular graft products, but we cannot estimate what portion of such costs will be reimbursed and our products may not continue to be approved for reimbursement. In addition, changes in the health care system may affect the reimbursability of future products. If coverage is not expanded or if the reimbursement levels are not increased or are partially or completely reduced, our revenues would be reduced.

If we fail to obtain approval from the FDA and from foreign regulatory authorities, we cannot market and sell our products under development in the United States and in other countries, and if we fail to adhere to ongoing FDA Quality System Regulations, the FDA may withdraw our market clearance or take other action.

Before we can market new products in the United States, we must obtain clearance from the FDA. This process is lengthy and uncertain. In the United States, one must obtain clearance from the FDA of a 510(k) pre-market notification or approval of a more extensive submission known as a pre-market approval, or PMA, application. If the FDA concludes that any of our products does not meet the requirements to obtain clearance under Section 510(k) of the Federal Food, Drug, and Cosmetic Act, then we would be required to file a PMA application. The process for a PMA application is lengthy, expensive and typically requires extensive pre-clinical and clinical trial data.

We may not obtain clearance of a 510(k) notification or approval of a PMA application with respect to any of our products on a timely basis, if at all. If we fail to obtain timely clearance or approval for our products, we will not be able to market and sell our products, thereby harming our ability to generate sales. The FDA may also limit the claims that we can make about our products. We may also be required to obtain clearance of a 510(k) notification or PMA Supplement from the FDA before we can market products that have been cleared, but we have since modified or that

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we subsequently wish to market for new disease indications.

The FDA also requires us to adhere to Quality System Regulations, which include production design controls, testing, quality control, storage and documentation procedures. The FDA may at any time inspect our facilities to determine whether we have adequate compliance. Compliance with Quality System Regulations for medical devices is difficult and costly. In addition, we may not be found to be compliant as a result of future changes in, or interpretations of, regulations by the FDA or other regulatory agencies. If we do not achieve compliance, the FDA may withdraw marketing clearance, require product recall or take other enforcement action, which in each case would harm our business. Any change or modification to a device is required to be made in compliance with Quality System Regulations, which compliance may cause interruptions or delays in the marketing and sale of our products. The FDA also requires device manufacturers to submit reports regarding deaths, serious injuries and certain malfunctions relating to use of their products.

Sales of our products outside the United States are subject to foreign regulatory requirements that vary from country to country. The time required to obtain approvals from foreign countries may be longer or shorter than that required for FDA approval, and requirements for foreign licensing may differ from FDA requirements.

The federal, state and foreign laws and regulations regarding the manufacture and sale of our products are subject to future changes, as are administrative interpretations and policies of regulatory agencies. If we fail to comply with applicable federal, state or foreign laws or regulations, we could be subject to enforcement actions. Enforcement actions could include product seizures, recalls, withdrawal of clearances or approvals, and civil and criminal penalties, which in each case would harm our business.

Certain lawsuits have been filed against us.

Commencing on or about August 3, 2004, several Federal securities law putative class action suits were filed in the United States District Court for the Northern District of California on behalf of purchasers of the publicly traded securities of the Company between April 28, 2004 and June 29, 2004. These suits were consolidated in a consolidated complaint filed on or about January 18, 2005. The complaint seeks to recover unspecified damages on behalf of all purchasers of our publicly traded securities during the class period.

On or about September 1, 2004, a shareholder derivative action entitled *Wong v. Grossman* was filed in the California Superior Court for Alameda County based upon essentially the same facts as the Federal securities suit. This action names the individual members of our Board of Directors, our Chief Executive Officer and our former Chief Financial Officer as defendants.

In June of 2004, MicroMed Technology, Inc., a potential competitor of ours, sued us in Texas. MicroMed sought injunctive relief against us in connection with our HeartMate II Phase I clinical trial on the grounds that we had provided the HeartMate II VAD to clinical sites without charge and that doing so was a violation of Texas anti-trust law. In addition to injunctive relief, the plaintiff is seeking unspecified damages and fees, including those arising from potential sales of its VAD products which plaintiff alleges it lost due to our HeartMate II clinical trial. We have successfully defended ourselves against MicroMed s requests for injunctive relief and will continue to vigorously defend any and all of the claims made by MicroMed in this action.

We believe that the claims asserted in the MicroMed action, and both the Federal securities law putative class action and the state shareholder derivative action are without merit. We have filed a motion to dismiss in the Federal securities law putative class action and the shareholder suit currently is stayed through to at least early July 2005.

We are unable to predict at this time the final outcome of these actions.

We carry sufficient insurance to cover what management believes to be any reasonable exposure on these actions; however, we cannot give assurance that our insurance will cover all costs or other exposures we may incur with respect to these actions.

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If hospitals do not conduct Destination Therapy procedures using our VAD, our product sales will be diminished.

The use of our VADs as long-term therapy in patients who are not candidates for heart transplantation (i.e., they are Destination Therapy patients) was approved by the FDA in 2002, and was approved for reimbursement by the CMS in late 2003.

The number of Destination Therapy procedures actually performed depends on many factors, most of which are out of our direct control, including:

- the number of CMS sites approved for Destination Therapy;
- the clinical outcomes of Destination Therapy procedures;
- cardiologists and referring physicians education, and their commitment to Destination Therapy;
- the economics of the Destination Therapy procedure for individual hospitals, which include the costs of the VAD and related pre- and post- operative procedures and their reimbursement;
- the impact of changes in reimbursement rates on the timing of purchases of VADs for Destination Therapy; and
- the economics for individual hospitals of not conducting a Destination Therapy procedure, including the costs and related reimbursements of long-term hospitalization.

The different outcomes of these and other factors, and their timing, will have a significant impact on our future operating results. Sales of our VADs for Destination Therapy have proved slower than we had originally anticipated, and we are unable to predict when, if ever, these sales will generate significant revenue for us.

The long and variable sales and deployment cycles for our VAD systems may cause our product sales and operating results to vary significantly, which increases the risk of an operating loss for any given fiscal period.

Our VAD systems have lengthy sales cycles and we may incur substantial sales and marketing expenses and expend significant effort without making a sale. Even after making the decision to purchase our VAD systems, our customers often deploy our products slowly. For example, the length of time between initial contact with cardiac surgeons and the purchase of our VAD systems is generally between nine and eighteen months. In addition, the cardiac centers that buy the majority of our products are usually led by cardiac surgeons who are heavily recruited by competing centers or by centers looking to increase their profiles. When one of these surgeons moves between centers we sometimes experience a temporary but significant reduction in purchases by the departed center while it replaces its lead surgeon. As a result, it is difficult for us to predict the quarter in which customers may purchase our VAD systems and our product sales and operating results may vary significantly from quarter to quarter, which increases the risk of an operating loss for us for any given quarter. In particular, sales of our VADs for Destination Therapy have been lower than we had originally anticipated, and we cannot predict when, if ever, sales of our VADs for this indication will generate the level of revenues we expect.

Physicians may not accept or continue to accept our current products and products under development.

The success of our current and future products will require acceptance or continued acceptance by cardiovascular and vascular surgeons, and other medical professionals. Such acceptance will depend on clinical results and the conclusion by these professionals that our products are safe, cost-effective and acceptable methods of treatment. Even if the safety and efficacy of our future products are established, physicians may elect not to use them

for a number of reasons. These reasons could include the high cost of our VAD systems, restrictions on coverage, unfavorable reimbursement from health care payors, or use of alternative therapies. Also, economic, psychological, ethical and other concerns may limit general acceptance of our ventricular assist, graft and other products.

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Our future product sales will be affected by the number of heart transplants conducted.

A significant amount of our current product sales is generated by our VADs implanted temporarily in patients awaiting heart transplants. The number of heart transplants conducted worldwide depends on the number of hearts available to transplant, which number in turn depends on the death rate of otherwise healthy people from events such as automobile accidents.

We have experienced rapid growth and changes in our business, and our failure to manage this and any future growth could harm our business.

The number of our employees has substantially increased during the past several years. We expect to continue increasing the number of our employees, and our business may suffer if we do not manage and train our new employees effectively. Our product sales may not continue to grow at a rate sufficient to support the costs associated with an increasing number of employees. Any future periods of rapid growth may place significant strains on our managerial, financial and other resources. The rate of any future expansion, in combination with our complex technologies and products, may demand an unusually high level of managerial effectiveness in anticipating, planning, coordinating and meeting our operational needs as well as the needs of our customers.

If we fail to successfully introduce new products, our future growth may suffer.

As part of our growth strategy, we intend to develop and introduce a number of new products and product improvements. We also intend to develop new indications for our existing products. For example, we are currently developing updated versions of our HeartMate products. If we fail to commercialize these new products, product improvements and new indications on a timely basis, or if they are not well accepted by the market, our future growth may suffer.

Amortization of our intangible assets, which represent a significant portion of our total assets, will adversely affect our net income and we may never realize the full value of our intangible assets.

A substantial portion of our assets are comprised of goodwill and purchased intangible assets. We may not receive the recorded value for our intangible assets if we sell or liquidate our business or assets. The material concentration of intangible assets increases the risk of a large charge to earnings if the revenue from, and recoverability of, these intangible assets is impaired. We completed an assessment of the current values of our intangible assets at the year ended 2004 and determined that no impairment exists, however the lives have been modified on several components of these identified assets. In the event, however, of such a charge to net income, the market price of our common stock could be adversely affected. For example, in the first quarter of 2004, we completed an assessment of the final results from the feasibility clinical trial for the Aria CABG graft, which was ongoing through fiscal 2003. Based on the clinical trial results, we determined not to devote additional resources to development of the Aria graft. Upon the decision to discontinue product development, we recorded an impairment charge of approximately $9 million as of January 3, 2004 to write off purchased intangible assets related to the Aria graft, recorded as a result of our merger with TCA

We rely on specialized suppliers for certain components and materials in our products and alternative suppliers may not be available.

We depend on a number of custom-designed components and materials supplied by other companies including, in some cases, single source suppliers for components, instruments and materials used in our VAD products and blood testing products. For example, single sources currently manufacture and supply our ProTime and Hemoglobin instruments and the heart valves used in our HeartMate products. The suppliers of our ProTime and Hemoglobin

products are located in China and Germany, respectively. We do not have long-term written agreements with most of our vendors and from these vendors receive components on a purchase order basis

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only. If we need alternative sources for key raw materials or component parts for any reason, such alternative sources may not be available and our inventory may not be sufficient to fill orders before we find alternative suppliers or begin manufacturing these components or materials ourselves. Cessation or interruption of sales of circulatory support products or our point-of-care products would seriously harm our business, financial condition and results of operations.

Alternative suppliers, if available, may not agree to supply us. In addition, we may require FDA approval before using new suppliers or manufacturing our own components or materials. Existing suppliers could also become subject to an FDA enforcement action, which could also disrupt our supplies. If alternative suppliers are not available, we may not have the expertise or resources necessary to produce these materials or component parts internally.

Because of the long product development cycle in our business, suppliers may discontinue components upon which we rely before the end of life of our products. In addition, the timing of the discontinuation may not allow us time to develop and obtain FDA approval for a replacement component before we exhaust our inventory of the legacy component.

If suppliers discontinue components on which we rely, we may have to:

pay premium prices to our suppliers to keep their production lines open or to obtain alternative suppliers;

buy substantial inventory to last through the scheduled end of life of our product, or through such time that we will have a replacement product developed and approved by the FDA; or

stop shipping the product in which the legacy component is used once our inventory of the discontinued component is exhausted.

Any of these interruptions in the supply of our materials could result in substantial reductions in product sales and increases in our production costs.

If we fail to compete successfully against our existing or potential competitors, our product sales or operating results may be harmed.

Competition from medical device companies and medical device subsidiaries of health care and pharmaceutical companies is intense and is expected to increase. Principal competitors for the VAD system include WorldHeart Corporation, MicroMed Technology, Inc., Abiomed, Inc., and Berlin Heart in Europe. Principal competitors in the vascular graft market include W.L. Gore, Inc., C.R. Bard Corporation, which is also a distributor of our *Vectra* product line, and Boston Scientific Corporation. Principal competitors in the hospital coagulation and blood gas monitoring equipment market include the Cardiac Surgery Division of Medtronic, Inc., iSTAT, Radiometer, Abbott Diagnostics, and Instrument Laboratories. Our primary competitor in the skin incision device market is Becton, Dickson and Company. Competitors in the alternate site (non-hospital) point-of-care diagnostics market include Roche Diagnostics and HemoSense.

Many of our competitors have substantially greater financial, technical, distribution, marketing and manufacturing resources than we have. Accordingly, our competitors may be able to develop, manufacture and market products more efficiently and at a lower cost than we can. We expect that the key competitive factors will include the relative speed with which we can:

develop products;

complete clinical testing;

receive regulatory approvals; and

manufacture and sell commercial quantities of products.

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Large medical device companies dominate the markets in which ITC competes. We expect that any growth in this market will come from expanding our market share at the expense of other companies, and from testing being shifted away from central laboratories to the point-of-care. However, this market segment is very competitive, and includes the following potential drivers:

New drug therapies under development may not require the intense monitoring of a patient s coagulation that the current anti-coagulation drug of choice (Heparin) requires.

New competitors might enter the market with broader test menus.

Any of the devices of our competitors in clinical trials and in development could prove to be clinically superior, easier to implant, and/or less expensive than current commercialized devices, thereby impacting Thoratec s marketshare.

We may encounter problems manufacturing our products.

We may encounter difficulties manufacturing our products. We do not have experience in manufacturing some of our products in the commercial quantities that might be required if we receive FDA approval of several or all of the products and indications currently under development, including the HeartMate II VAD. If we have difficulty manufacturing any of our products, our business will be harmed.

Since we depend upon distributors, if we lose a distributor or a distributor fails to perform, our operations may be harmed.

With the exception of Canada and the larger countries in Europe, we sell our Thoratec VAD and HeartMate systems in foreign markets through distributors. In addition, we sell our vascular access graft products through the Bard Peripheral Vascular division of C.R. Bard Corporation (which is also a competitor of ours) in the United States, and selected countries in Europe, the Middle East and Northern Africa and through Goodman Co. Ltd. in Japan. Substantially all of the international operations and a large portion of the Alternate Site domestic operations of ITC are conducted through distributors. For the quarter ended April 2, 2005, 16% of ITC s total product sales were through Cardinal Healthcare, a distributor of our blood coagulation testing equipment and skin incision devices.

To the extent we rely on distributors, our success will depend upon the efforts of others, over which we may have little or no control. If we lose a distributor or a distributor fails to perform to our expectations, our product sales may be harmed.

Changes we make to our method of distributing and selling our products could hurt our relationship with distributors and their customers.

In March 2004, we began changing our manner of distributing our Hemochron product line to our hospital point-of-care customers in the United States from a distributor model to a direct sales model.

This transition to a direct sales model necessitated expanding the sales, technical service, customer service and shipping headcount at ITC in order to provide our customers with the support and service that they historically obtained from our distributors, resulting in an increase in our sales and general and administrative costs. This transition process concluded in the first quarter of 2005, which resulted in the United States hospital point-of-care market now being served directly and exclusively by ITC. This transition and its execution involve significant risks, including:

the promotion by our former distributors of products from competitors rather than our products;

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the potential loss of customers who prefer to deal with a particular distributor; and

the challenges and costs associated with building an effective direct sales force.

If we fail to build an effective direct sales force for our hospital point-of-care product lines, our revenues may fail to increase as expected or could decrease, which could adversely affect our results of operations and financial condition.

Our inability to protect our proprietary technologies or an infringement of others patents could harm our competitive position.

We rely on patents, trade secrets, copyrights, know-how, trademarks, license agreements and contractual provisions to establish our intellectual property rights and protect our products. These legal means, however, afford only limited protection and may not adequately protect our rights. In addition, we cannot assure you that any of our pending patent applications will issue. The Patent and Trademark Office, or PTO, may deny or significantly narrow claims made under patent applications and the issued patents, if any, may not provide us with commercial protection. We could incur substantial costs in proceedings before the PTO or in any future litigation to enforce our patents in court. These proceedings could result in adverse decisions as to the validity and/or enforceability of our patents. In addition, the laws of some of the countries in which our products are or may be sold may not protect our products and intellectual property to the same extent as U.S. laws, if at all. We may be unable to protect our rights in trade secrets and unpatented proprietary technology in these countries.

Our commercially available VAD products, which account for a majority of our sales, generally are not protected by any patents. We rely principally on trade secret protection and, to a lesser extent, patents to protect our rights to our HeartMate product line. We rely principally on patents to protect our coagulation testing equipment, skin incision devices, Hemochron disposable cuvettes, IRMA analyzer, IRMA disposable cartridges, and Hgb Pro disposable test strips.

We seek to protect our trade secrets and unpatented proprietary technology, in part, with confidentiality agreements with our employees and consultants. Although it is our policy to require that all employees and consultants sign such agreements, we cannot assure you that every person who gains or has gained access to such information has done so. Moreover, these agreements may be breached and we may not have an adequate remedy.

Our products may be found to infringe prior or future patents owned by others. We may need to acquire licenses under patents belonging to others for technology potentially useful or necessary, and such licenses may not be available to us. We could incur substantial costs in defending suits brought against us on such patents or in bringing suits to protect our patents or patents licensed by us against infringement.

For example, in 2003, a patent infringement claim was filed against us by Bodycote Materials Testing Canada, Inc. and David C. MacGregor, M.D. related to materials used in the HeartMate LVAS. On February 3, 2004, we settled the claim and recorded a charge of $2.3 million in the fourth quarter of 2003 for the settlement and related legal costs.

Product liability claims could damage our reputation and hurt our financial results.

Our business exposes us to an inherent risk of potential product liability claims related to the manufacturing, marketing and sale of human medical devices. We maintain a limited amount of product liability insurance. Our insurance policies generally must be renewed on an annual basis. We may not be able to maintain or increase such insurance on acceptable terms or at reasonable costs, and such insurance may not provide us with adequate coverage against potential liabilities. A successful claim brought against us in excess, or outside, of our insurance coverage

could seriously harm our financial condition and results of operations. Claims against us, regardless of their merit or potential outcome, may also reduce our ability to obtain physician acceptance of our products or expand our business.

Identified quality problems can result in substantial costs and write-downs.

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FDA regulations require us to track materials used in the manufacture of our products, so that any problems identified in a finished product can easily be traced back to other finished products containing the defective materials. In some instances, identified quality issues require scrapping or expensive rework of the affected lot(s), not just the tested defective product, and could also require us to stop shipments.

In addition, since some of our products are used in situations where a malfunction can be life threatening, identified quality issues can result in the recall and replacement, generally free of charge, of substantial amounts of product already implanted or otherwise in the marketplace.

Any quality issue identified can therefore result in substantial costs and write-offs, which could materially harm our financial results.

If we make acquisitions or divestitures, we could encounter difficulties that harm our business.

We may acquire companies, products or technologies that we believe to be complementary to our business. If we do so, we may have difficulty integrating the acquired personnel, operations, products or technologies and we may not realize the expected benefits of any such acquisition. In addition, acquisitions may dilute our earnings per share, disrupt our ongoing business, distract our management and employees and increase our expenses, which could harm our business. We may also sell businesses or assets as part of our strategy or if we receive offers from third parties. If we do so, we may sell an asset or business for less than its full value.

Our non-U.S. sales present special risks.

A substantial portion of our total sales occurs outside the United States. We anticipate that sales outside the United States and U.S. export sales will continue to account for a significant percentage of our product sales and we intend to continue to expand our presence in international markets. Non-U.S. sales are subject to a number of special risks. For example:

- we generally sell many of our products at a lower price outside the United States;
- sales agreements may be difficult to enforce;
- receivables may be difficult to collect through a foreign country s legal system;
- foreign customers may have longer payment cycles;
- foreign countries may impose additional withholding taxes or otherwise tax our foreign income, impose tariffs or adopt other restrictions on foreign trade;
- U.S. export licenses may be difficult to obtain;
- intellectual property rights may be more difficult to enforce in foreign countries;
- terrorist activity or war may interrupt distribution channels or adversely impact our customers or employees; and
- fluctuations in exchange rates may affect product demand and adversely affect the profitability, in U.S. dollars, of products sold in foreign markets where payments are made in local currencies.

Any of these events could harm our operations or operating results.

Any claims relating to improper handling, storage or disposal of hazardous chemicals and biomaterials could be time consuming and costly.

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Producing our products requires the use of hazardous materials, including chemicals and biomaterials. We cannot eliminate the risk of accidental contamination or discharge and any resultant injury from these materials.

We could be subject to both criminal liability and civil damages in the event of an improper or unauthorized release of, or exposure of individuals to, hazardous materials. In addition, claimants may sue us for injury or contamination that results from our use or the use by third parties of these materials, and our liability may exceed our total assets. Compliance with environmental laws and regulations is expensive, and current or future environmental regulations may impair our research, development or production efforts or harm our operating results.

The occurrence of a catastrophic disaster or other similar events could cause damage to our facilities and equipment, which would require us to cease or curtail operations.

We are vulnerable to damage from various types of disasters, including earthquake, fire, terrorist acts, flood, power loss, communications failures and similar events. For example, in October 1989, a major earthquake that caused significant property damage and a number of fatalities struck near the area in which our Pleasanton, California facility is located. If any such disaster were to occur, we may not be able to operate our business at our facilities, in particular because our premises require FDA approval, which could result in significant delays before we can manufacture product from a replacement facility. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Therefore, any such catastrophe could seriously harm our business and results of operations.

If we are unable to favorably assess the effectiveness of our internal control over financial reporting, or if our independent auditors are unable to provide an unqualified attestation report on our assessment, our stock price could be adversely affected.

Under the Sarbanes-Oxley Act of 2002, or the Act, beginning in 2004 we are required to assess the effectiveness of our internal controls for financial reporting annually and assert that such internal controls are effective. Our independent auditors must evaluate management s assessment of the effectiveness of our internal controls over financial reporting and render an opinion on management s assessment and the effectiveness of our internal controls over financial reporting. The Act has resulted in and is likely to continue to result in increased expenses, and has required and is likely to continue to require significant efforts by management and other employees. Although we believe that our efforts will enable us to remain compliant under the Act, we can give no assurance that in the future such efforts will be successful. Our business is complex and involves significant judgments and estimates as described in our Critical Accounting Estimates. If we have material weaknesses in internal controls, we will not be able to assert that our internal controls over financial reporting are effective, which could adversely effect investor confidence in us and the market price of our common stock.

Fluctuations in foreign currency exchange rates could result in declines in our reported sales and earnings.

Because some of our international sales are denominated in local currencies and not in U.S. dollars, our reported sales and earnings are subject to fluctuations in foreign exchange rates. At present, we use forward foreign currency contracts to hedge the gains and losses created by the remeasurement of non-functional currency denominated assets and liabilities. However, we do not engage in hedge exposures that will arise from future sales. As a result, sales occurring in the future that are denominated in foreign currencies may be translated into U.S. dollars at a less favorable rate than our current exchange rate environment resulting in reduced revenues and earnings.

The competition for qualified personnel is particularly intense in our industry. If we are unable to retain or hire key personnel, we may not be able to sustain or grow our business.

Our ability to operate successfully and manage our potential future growth depends significantly upon retaining key research, technical, sales, marketing, managerial and financial personnel, and attracting and retaining additional highly qualified personnel in these areas. We face intense competition for such personnel, and we may not be able to attract and retain these individuals. We compete for talent with numerous companies, as well as

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universities and nonprofit research organizations, throughout all our locations. The loss of key personnel for any reason or our inability to hire and retain additional qualified personnel in the future could prevent us from sustaining or growing our business. Our success will depend in large part on the continued services of our research, managerial and manufacturing personnel. We cannot assure you that we will continue to be able to attract and retain sufficient qualified personnel.

Risks Related to the Notes and Our Common Stock

Our debt obligations expose us to risks that could adversely affect our business, operating results and financial condition, and prevent us from fulfilling our obligations under the notes.

We have a substantial level of debt. As of April 2, 2005, we had $143.8 million of outstanding indebtedness. The level of our indebtedness, among other things, could:

make it difficult for us to make payments on our debt as described below;

make it difficult for us to obtain any necessary financing in the future for working capital, capital expenditures, debt service, acquisitions or general corporate purposes;

limit our flexibility in planning for or reacting to changes in our business;

reduce funds available for use in our operations;

impair our ability to incur additional debt because of financial and other restrictive covenants proposed for any such additional debt;

make us more vulnerable in the event of a downturn in our business or an increase in interest rates; or

place us at a possible competitive disadvantage relative to less leveraged competitors and competitors that have better access to capital resources.

If we experience a decline in product sales due to any of the factors described in this Risk Factors section or otherwise, we could have difficulty paying interest or principal amounts due on our indebtedness. If we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments, or if we fail to comply with the various requirements of our indebtedness, including the notes, we would be in default, which would permit the holders of our indebtedness to accelerate the maturity of the indebtedness and could cause defaults under our other indebtedness. Any default under our indebtedness could have a material adverse effect on our business, operating results and financial condition.

The notes are unsecured and rank pari passu with our other senior subordinated debt; the notes are subordinated to our senior debt and structurally subordinated to all liabilities of our subsidiaries.

The notes are unsecured (except to the limited extent described under Description of Notes Security) and subordinated in right of payment in full to all of our senior indebtedness (including secured indebtedness). As a result, in the event of any liquidation, dissolution, bankruptcy or upon acceleration of the notes due to an event of default under the indenture governing the notes and in certain other events, our assets will be available to pay obligations on the notes only after all such senior indebtedness has been paid in full. As of April 2, 2005, excluding trade payables, we had $143.8 million of indebtedness outstanding.

None of our subsidiaries has guaranteed our obligations under, or has any obligation to pay any amounts due on, the notes. As a result, the notes are effectively subordinated to all liabilities of our subsidiaries. Our rights and the rights of our creditors, including holders of the notes, to participate in the assets of any of our subsidiaries upon their liquidation or recapitalization will generally be subject to the prior claims of those subsidiaries creditors. The ability of our subsidiaries to pay dividends and make other payments to us may be restricted by, among other things, applicable corporate and other laws and regulations, as well as agreements to which our subsidiaries may

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become a party. As of April 2, 2005, our subsidiaries had no outstanding indebtedness after than trade payables and intercompany liabilities.

The notes do not restrict our ability to incur additional debt or to take other actions that could negatively impact holders of the notes.

We are not restricted under the terms of the notes from incurring additional indebtedness, including other senior, senior subordinated or secured debt. In addition, the limited covenants applicable to the notes do not restrict our ability to pay dividends, issue or repurchase stock or other securities or require us to achieve or maintain any minimum financial results relating to our financial position or results of operations. Our ability to recapitalize, incur additional debt and take a number of other actions that are not limited by the terms of the notes could have the effect of diminishing our ability to make payments on the notes when due. In addition, the indenture does not afford protection to holders of the notes in the event of a fundamental change except to the extent described under Description of Notes Repurchase of the Notes at the Option of Holders upon a Fundamental Change.

Short-term portion of loans

3,799

3,842

Total current liabilities

40,114

38,113

Long-term liabilities

Long-term portion of capital leases

4,583

5,378

Long-term portion of loans, net

67,531

70,259

Revolving credit facility, net

24,461

21,799

Deferred income tax liability, net

7,548

14,973

Total long-term liabilities

104,123

112,409

Total liabilities

144,237

150,522

Commitments and contingencies - see Note I

Redeemable convertible preferred stock

Series A Redeemable Convertible Preferred Stock, $0.001 par value, (50,000,000 shares authorized; 6,600,000 shares issued and outstanding)

30,125

22,873

Stockholders' equity

Common stock, $0.001 par value, (250,000,000 shares authorized; 80,346,946 and 78,571,158 shares issued and outstanding, respectively)

80

79

Additional paid-in capital

229,006

216,104

Accumulated deficit

(59,553

)

(52,460

)

Total stockholders’ equity

169,533

163,723

Total liabilities, redeemable convertible preferred stock and stockholders' equity

$

343,895

$

337,118

See notes to unaudited consolidated financial statements

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NEOGENOMICS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2017	2016	2017	2016
NET REVENUE				
Clinical testing	$56,186	$55,739	$172,668	$166,674
Pharma Services	6,866	5,022	18,150	16,919
Total Revenue	63,052	60,761	190,818	183,593
COST OF REVENUE	34,242	33,416	103,634	100,471
GROSS PROFIT	28,810	27,345	87,184	83,122
Operating expenses:				
General and administrative	23,267	19,025	66,743	55,810
Research and development	1,270	967	3,080	3,719
Sales and marketing	6,577	5,958	18,466	18,084
Loss on sale of Path Logic	1,058	—	1,058	—
Total operating expenses	32,172	25,950	89,347	77,613
INCOME (LOSS) FROM OPERATIONS	(3,362)	1,395	(2,163)	5,509
Interest expense, net	1,398	1,468	4,173	4,509
Income (loss) before taxes	(4,760)	(73)	(6,336)	1,000
Income tax (benefit) expense	340	(6)	(539)	500
NET INCOME (LOSS)	(5,100)	(67)	(5,797)	500
Deemed dividends on preferred stock	912	1,840	2,734	5,520
Amortization of preferred stock beneficial conversion feature	1,739	3,727	5,122	11,180
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	$(7,751)	$(5,634)	$(13,653)	$(16,200)
NET LOSS PER SHARE ATTRIBUTABLE TO COMMON STOCKHOLDERS				
Basic	$(0.10)	$(0.07)	$(0.17)	$(0.21)
Diluted	$(0.10)	$(0.07)	$(0.17)	$(0.21)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic	79,617	78,145	79,208	77,224
Diluted	79,617	78,145	79,208	77,224

See notes to unaudited consolidated financial statements.

NEOGENOMICS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Nine Months Ended September 30,	
CASH FLOWS FROM OPERATING ACTIVITIES	2017	2016
Net income (loss)	$(5,797)	$500
Adjustments to reconcile net income (loss) to net cash provided by		
operating activities:		
Depreciation	11,739	11,550
Amortization of intangibles	5,201	5,454
Amortization of debt issue costs	330	532
Loss on sale of Path Logic	1,058	-
Stock based compensation – options, restricted stock and warrants	5,812	4,024
Provision for bad debts	13,026	8,183
Changes in assets and liabilities, net:		
(Increase) in accounts receivable, net of write-offs	(20,916)	(9,424)
(Increase) in inventories	(37)	(844)
(Increase) in prepaid expenses	(406)	(1,482)
(Increase) in other current assets	(98)	(46)
Increase in accounts payable and other liabilities	2,366	3,271
Net cash provided by operating activities	12,278	21,718
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(10,167)	(5,328)
Net cash used in investing activities	(10,167)	(5,328)
CASH FLOWS FROM FINANCING ACTIVITIES		
Advances from revolving credit facility, net	2,496	—
Repayment to revolving credit facility	—	(10,044)
Repayment of capital lease obligations/loans	(4,126)	(3,874)
Repayment on term loan, net	(2,816)	(413)
Proceeds from the exercise of options, warrants and ESPP shares, net of transaction expenses	2,218	3,456
Payments of equity issue costs	(197)	—
Net cash (used in) financing activities	(2,425)	(10,875)
Net change in cash and cash equivalents	(314)	5,515
Cash and cash equivalent, beginning of period	12,525	23,420
Cash and cash equivalents, end of period	$12,211	$28,935
Supplemental disclosure of cash flow information:		
Interest paid	$3,879	$3,993
Income taxes paid	$272	$228

Supplemental disclosure of non-cash investing and financing information:		
Equipment acquired under capital lease/loan obligations	$3,240	$4,907
Deemed dividends on preferred stock	$2,734	$5,520
Amortization of preferred stock beneficial conversion feature	$5,122	$11,180
Purchase of customer list through issuance of restricted stock	$4,466	$-

See notes to unaudited consolidated financial statements.

NEOGENOMICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unaudited

Note A – Nature of Business and Basis of Presentation

NeoGenomics, Inc., a Nevada corporation (the “Parent”), and its subsidiaries, NeoGenomics Laboratories, Inc., a Florida corporation (“NEO” or, “NeoGenomics Laboratories”), NeoGenomics Bioinformatics Inc., a Florida corporation, Path Labs LLC., a Delaware limited liability company (“PathLogic”) and Clarient Inc., a Delaware corporation, and its wholly owned subsidiary Clarient Diagnostic Services, Inc. (together, “Clarient”), (collectively referred to as “we”, “us”, “our”, “NeoGenomics”, or the “Company”), operates as a certified “high complexity” clinical laboratory in accordance with the federal government’s Clinical Laboratory Improvement Act, as amended (“CLIA”), and is dedicated to the delivery of clinical diagnostic services to pathologists, oncologists, urologists, hospitals, and other laboratories throughout the United States and Europe.

The accompanying interim consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information. These accompanying interim consolidated financial statements include the accounts of the Parent and its subsidiaries. All intercompany transactions and balances have been eliminated in the accompanying interim consolidated financial statements.

Certain information and footnote disclosures normally included in the Company’s annual audited consolidated financial statements and accompanying notes have been condensed or omitted in these accompanying interim consolidated financial statements. Accordingly, the accompanying interim consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company’s annual report on Form 10-K for the year ended December 31, 2016, filed with the SEC on March 14, 2017.

The results of operations presented in this quarterly report on Form 10-Q are not necessarily indicative of the results of operations that may be expected for any future periods. In the opinion of management, these unaudited consolidated financial statements include all adjustments and accruals, consisting only of normal recurring adjustments that are necessary for a fair statement of the results of all interim periods reported herein.

We have one reportable operating segment that delivers testing services to hospitals, pathologists, oncologists, other clinicians, and researchers, which represents 100% of the Company’s consolidated assets, net revenues and net income (loss) for the three and nine months ended September 30, 2017 and 2016. We have evaluated our segments based on how the Chief Operating Decision Maker (“CODM”), our Chief Executive Officer, reviews performance and makes decisions in managing the Company. At September 30, 2017, we provided services within the United States and Europe and had assets located within the United States and Europe.

We have two primary types of customers, clinical and pharma. Our clinical customers include community based pathology practices, oncology groups, hospitals and academic centers. Our pharma customers include pharmaceutical companies to whom we provide testing and other services to support their studies and clinical trials. As we grow, we continue to assess the information available to the CODM. Currently, discrete financial information is not available to the CODM about the separate financial performance of our clinical and our pharma customers. As we continue to grow and focus separately on the two customer types we will routinely assess the information available and reviewed by the CODM and determine if we meet the criteria for having separate segments.

Correction of Immaterial Accounting Error

The Company performed an internal analysis in the third quarter of 2017 which identified an immaterial error in the revenue reported in our Form 10-K for the year ended December 31, 2016, Form 10-Q for the quarter ended March 31, 2017 and Form 10-Q for the three and six months ended June 30, 2017. We have concluded that the error identified was not material to any prior annual or interim periods. We assessed the extent of this error and it was corrected in the third quarter of 2017, resulting in a reduction of revenue, and thus a corresponding reduction in accounts receivable of $2.4 million and $0.6 million for the three and nine months ended September 30, 2017, respectively. See Item 4. Controls and Procedures for additional details regarding this error.

Note B – Recently Adopted and Issued Accounting Guidance

Adopted

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations. This standard clarifies the definition of a business and provides guidance on when transactions should be accounted for as acquisitions of assets and when they should be accounted for as acquisitions of businesses. The Company early adopted this standard on July 1, 2017 and applied this guidance to the customer list

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that was acquired on August 1, 2017. The customer list acquired was not determined to meet the definition of a business under this standard and was therefore determined to be an asset acquisition.

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Improvements to Employee Share-Based Payment Accounting. The standard update required excess tax benefits and tax deficiencies to be recorded directly through earnings as a component of income tax expense. Under previous GAAP, these differences were generally recorded in additional paid-in capital and thus had no impact on net income. The change impacted the computation of diluted earnings per share, and the cash flows associated with those items are now classified as operating activities on the condensed statements of consolidated cash flows. Entities were permitted to make an accounting policy election for the impact of forfeitures on the recognition of expense for share-based payment awards. Forfeitures could be estimated, as required under previous GAAP, or recognized when they occur.

The Company adopted this ASU on January 1, 2017 using the transition method prescribed for each applicable provision:

- Based on the implementation guidance, previously unrecognized excess tax benefits should be on a modified retrospective basis beginning in the period the guidance is adopted. Accordingly, the Company recorded an increase in deferred tax assets and an offsetting cumulative-effect adjustment to retained earnings of $6.6 million as of January 1, 2017 for excess tax benefits not previously recognized.
- Based on the implementation guidance, all excess tax benefits and tax deficiencies related to share based compensation will be reported in net income (loss) on a prospective basis. For the nine months ended September 30, 2017, no income (loss) was reported.
- The Company has elected to retrospectively adopt the requirement to present cash flows related to excess tax benefits as cash flows from operating activities. This adoption had no effect on cash flows for the nine months ended September 30, 2017.
- The Company has elected to recognize forfeitures in compensation cost as they occur.

Issued

In August 2017 the FASB issued ASU 2017-12, Derivatives and Hedging. This standard refines hedge accounting to better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. This update is effective for annual periods beginning after December 15, 2018 and interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-12 to have a material effect on its consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation – Stock Compensation. This standard provides guidance related to the scope of stock option modification accounting, to reduce diversity in practice and reduce cost and complexity regarding existing guidance. This update is effective for annual periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-09 to have a material effect on its consolidated financial statements.

In January 2017 the FASB issued ASU No. 2017-04, Intangibles – Goodwill and Other: Simplifying the Test for Goodwill Impairment. This standard eliminates Step 2 of the goodwill impairment test. Instead, an entity should perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. This update is effective for annual and interim periods beginning after December 15, 2021. Early adoption is permitted for interim or annual goodwill impairment tests performed after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material effect on its consolidated financial statements.

In August 2016, the FASB issued "ASU" 2016-15, Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments. This standard clarifies how specific cash receipts and cash payments are classified and presented in the statement of cash flows. This update is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-15 to have a material effect on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases. The update requires organizations to recognize lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous GAAP. ASU 2016-02 requires that a

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lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. ASU 2016-02 is effective for periods beginning after December 15, 2018 and interim periods within those periods. The adoption of this ASU will result in an increase on the balance sheet for lease liabilities and right-of-use assets. The Company is currently evaluating the quantitative impact that adopting ASU 2016-02 will have on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenues from Contracts with Customers. This standard update calls for a number of revisions in the revenue recognition rules. In August 2015, the FASB deferred the effective date of this ASU to the first quarter of 2018, with optional early adoption beginning in the first quarter of 2017. The ASU can be applied using a full retrospective method or a modified retrospective method of adoption. The Company expects to adopt this ASU in the first quarter of 2018 using a full retrospective method of adoption. We anticipate the adoption of this standard to impact our Pharma Services revenue, specifically the timing of revenue recognition for our long term research and clinical trials contracts. Many of these contracts have distinct terms which need to be evaluated separately, therefore, we are still in the process of contract review in order to determine the quantitative impact this standard will have on our Pharma Services revenue. We also expect this standard to impact our Clinical testing revenue. Under the new standard, substantially all of our bad debt expense which has historically been presented as part of selling, general and administrative expenses will be considered an implicit price concession and will be reported as a reduction in revenue. We also anticipate enhanced financial statement disclosures surrounding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The Company continues to assess the full impact the adoption of this standard will have on our financial statements.

Note C – Goodwill and Intangible Assets

Goodwill as of September 30, 2017 and December 31, 2016 was $147.0 million. There were no changes in the carrying amount of goodwill during these periods.

Intangible assets as of September 30, 2017 and December 31, 2016 consisted of the following (in thousands):

		September 30, 2017		
	Amortization Period	Cost	Accumulated Amortization	Net
Trade Name	24 months	$3,000	$ 2,633	$367
Customer Relationships	156 - 180 months	85,437	9,502	75,935
Non-Compete Agreement	24 months	29	1	28
Total		$88,466	$ 12,136	$76,330

		December 31, 2016		
	Amortization Period	Cost	Accumulated Amortization	Net
Trade Name	24 months	$3,000	$ 1,508	$1,492
Customer Relationships	156 - 180 months	$81,000	$ 5,428	$75,572
Total		$84,000	$ 6,936	$77,064

On August 31, 2017, the Company acquired a customer list from Ascend Genomics in exchange for 450,000 shares of restricted stock, see Note H – Equity. This customer relationship was recorded at fair value and is being amortized over 15 years. As part of the transaction, Ascend Genomics signed a non-compete agreement which was also recorded as an intangible asset and is being amortized over 2 years. We recorded approximately $1.7 and $1.8 million in straight-line amortization expense of intangible assets for the three month period ended September 30, 2017 and 2016, respectively. We recorded approximately $5.2 million and $5.5 million in straight-line amortization expense of intangible assets for the nine month period ended September 30, 2017 and 2016, respectively. The Company recorded amortization expense from customer relationships and trade names as a general and administrative expense.

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The estimated amortization expense related to amortizable intangible assets for each of the five succeeding fiscal years and thereafter as of September 30, 2017 is as follows (in thousands):

Remainder of 2017	$1,796
2018	5,710
2019	5,706
2020	5,696
2021	5,695
2022	5,695
Thereafter	46,032
Total	$76,330

Note D – Debt

The following table summarizes the long term debt at September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	December 31, 2016
Term Loan Facility	$72,188	$75,000
Revolving Credit Facility	25,399	22,900
Auto Loans	82	202
Capital leases	9,270	10,269
Total Debt	106,939	108,371
Less: Debt issuance costs	(1,878)	(2,202)
Less: Current portion of long-term debt	(8,486)	(8,733)
Total Long-Term Debt, net	$96,575	$97,436

The carrying value of the Company’s long-term capital lease obligations and term debt approximates its fair value based on the current market conditions for similar instruments.

Term Loan

On December 22, 2016, the Company entered into a Credit Agreement with Regions Bank as administrative agent and collateral agent. The Credit Agreement provided for a $75.0 million term loan facility (the “Term Loan Facility”). The Credit Agreement also provides incremental facility capacity of $50 million, subject to certain conditions. On

September 30, 2017 and December 31, 2016, the Company had current outstanding borrowings under the Term Loan of approximately $3.8 million and long-term outstanding borrowings of approximately $67.5 million and $70.1 million, net of unamortized debt issuance costs of $939,000 and $1.1 million, respectively. The debt issuance costs were recorded as a reduction in the carrying amount of the related liability and are being amortized over the life of the loan.

The Term Loan Facility bears interest at a rate per annum equal to an applicable margin plus, at NeoGenomics Laboratories' option, either (1) the Adjusted LIBOR rate for the relevant interest period, (2) an alternate base rate determined by reference to the greatest of (a) the prime lending rate of Regions, (b) the federal funds rate for the relevant interest period plus 0.5% per annum and (c) the one month LIBOR rate plus 1% per annum, or (3) a combination of (1) and (2). The applicable margin will range from 2.25% to 3.50% for LIBOR loans and 1.25% to 2.50% for base rate loans, in each case based on NeoGenomics Laboratories' consolidated leverage ratio (as defined in the Credit Agreement). Interest on borrowings under the Revolving Credit Facility is payable on the last day of each month, in the case of each base rate loan, and on the last day of each interest period (but no less frequently than every three months), in the case of Adjusted LIBOR loans. The Company entered into an interest rate swap agreement to hedge against changes in the variable rate of a portion of this debt. See Note E-Derivative Instruments and Hedging Activities for more information on this instrument.

The Term Loan Facility and amounts borrowed under the Revolving Credit Facility are secured on a first priority basis by a security interest in substantially all of the tangible and intangible assets of NeoGenomics Laboratories and the Guarantors. The Term Loan Facility contains various affirmative and negative covenants including ability to incur liens and encumbrances; make certain restricted payments, including paying dividends on its equity securities or payments to redeem, repurchase or retire its equity securities; enter

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into certain restrictive agreements; make investments, loans and acquisitions; merge or consolidate with any other person; dispose of assets; enter into sale and leaseback transactions; engage in transactions with its affiliates, and materially alter the business it conducts. In addition, the Company must meet certain maximum leverage ratios and fixed charge coverage ratios as of the end of each fiscal quarter commencing with the quarter ending March 31, 2017. The Company was in compliance with all required covenants as of September 30, 2017.

The Term Loan Facility has a maturity date of December 21, 2021. The Credit Agreement requires NeoGenomics Laboratories to mandatorily prepay the Term Loan Facility and amounts borrowed under the Revolving Credit Facility with (i) 100% of net cash proceeds from certain sales and dispositions, subject to certain reinvestment rights, (ii) 100% of net cash proceeds from certain issuances or incurrences of additional debt, (iii) beginning with the fiscal year ending December 31, 2017, 50% of excess cash flow (as defined), subject to a step down to 0% of excess cash flow if NeoGenomics Laboratories' consolidated leverage ratio is no greater than 2.75:1.0 and (iv) 100% of net cash proceeds from issuances of permitted equity securities by NeoGenomics Laboratories made in order to cure a failure to comply with the financial covenants. NeoGenomics Laboratories is permitted to voluntarily prepay the Term Loan Facility and amounts borrowed under the Revolving Credit Facility at any time without penalty.

Auto Loans

The Company has auto loans with various financial institutions. The auto loan terms range from 36-60 months and carry interest rates from 0.0% to 5.2%.

Capital Leases

The Company has entered into capital leases to purchase laboratory and office equipment. These leases expire at various dates through 2020 and the weighted average interest rate under such leases was approximately 4.81% at September 30, 2017. Most of these leases contain bargain purchase options that allow us to purchase the leased property for a minimal amount upon the expiration of the lease term. The remaining leases have purchase options at fair market value.

Property and equipment acquired under capital lease agreements are pledged as collateral to secure the performance of the future minimum lease payments.

Revolving Credit Facility

On December 22, 2016, the Company entered into a Credit Agreement with Regions Bank as administrative agent and collateral agent. The Credit Agreement provided for a $75.0 million revolving credit facility (the "Revolving Facility"). On September 30, 2017, and December 31, 2016, the Company had outstanding borrowings of

approximately $24.5 million and $21.8 million, net of unamortized debt issuance costs of $939,000 and $1.1 million, respectively.

The Revolving Credit Facility includes a $10 million swingline sublimit, with swingline loans bearing interest at the alternate base rate plus the applicable margin. Any principal outstanding under the Revolving Credit Facility is due and payable on December 21, 2021 or such earlier date as the obligations under the Credit Agreement become due and payable pursuant to the terms of the Credit Agreement. The Revolving Facility bears interest at a rate per annum equal to an applicable margin plus, at NeoGenomics Laboratories' option, either (1) the Adjusted LIBOR rate for the relevant interest period, (2) an alternate base rate determined by reference to the greatest of (a) the prime lending rate of Regions, (b) the federal funds rate for the relevant interest period plus 0.5% per annum and (c) the one month LIBOR rate plus 1% per annum, or (3) a combination of (1) and (2). The applicable margin will range from 2.25% to 3.50% for Adjusted LIBOR loans and 1.25% to 2.50% for base rate loans, in each case based on NeoGenomics Laboratories' consolidated leverage ratio. Interest on the outstanding principal of the Term Loan Facility will be payable on the last day of each month, in the case of each base rate loan, and on the last day of each interest period (but no less frequently than every three months), in the case of LIBOR loans.

The Credit Agreement requires NeoGenomics Laboratories to mandatorily prepay the Term Loan Facility and amounts borrowed under the Revolving Credit Facility with (i) 100% of net cash proceeds from certain sales and dispositions, subject to certain reinvestment rights, (ii) 100% of net cash proceeds from certain issuances or incurrences of additional debt, (iii) beginning with the fiscal year ending December 31, 2017, 50% of excess cash flow (minus certain specified other payments), subject to a step down to 0% of excess cash flow if NeoGenomics Laboratories' consolidated leverage ratio is no greater than 2.75:1.0 and (iv) 100% of net

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cash proceeds from issuances of permitted equity securities by NeoGenomics Laboratories made in order to cure a failure to comply with the financial covenants. NeoGenomics Laboratories is permitted to voluntarily prepay the Term Loan Facility and amounts borrowed under the Revolving Credit Facility at any time without penalty, subject to customary “breakage” costs with respect to prepayments of Adjusted LIBOR rate loans made on a day other than the last day of any applicable interest period.

Maturities of Long-Term Debt

Maturities of long-term debt at September 30, 2017 are summarized as follows (in thousands):

	Term Loan and Revolving Credit Facility	Capital Lease Obligations	Auto Loans	Total Long-Term Debt
Remainder of 2017	$ 938	$ 1,397	$ 12	$ 2,347
2018	3,750	4,677	49	8,476
2019	5,625	3,112	21	8,758
2020	5,625	617	-	6,242
2021	81,649	-	-	81,649
	97,587	9,803	82	107,472
Less: Interest on capital leases	-	(533)	-	(533)
	97,587	9,270	82	106,939
Less: Current portion of long-term debt	(3,750)	(4,687)	(49)	(8,486)
Less: Debt issuance costs	(1,878)	-	-	(1,878)
Long-term debt, net	$ 91,959	$ 4,583	$ 33	$ 96,575

Note E – Derivative Instruments and Hedging Activities

Cash Flow Hedges

In December of 2016, the Company entered into an interest rate swap agreement to reduce our exposure to interest rate fluctuations on our variable rate debt obligations. This derivative financial instrument is accounted for at fair value as a cash flow hedge which effectively modifies our exposure to interest rate risk by converting a portion of our floating rate debt to a fixed rate obligation, thus reducing the impact of interest rate changes on future interest expense.

We account for derivatives in accordance with FASB ASC Topic 815, see Note B-Summary of Significant Accounting Policies in Annual Report on Form 10-K for more information on our accounting policy related to derivative instruments and hedging activities.

Under this agreement, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest at 1.59%. The interest rate swap agreement was effective as of December 30, 2016 and a termination date of December 31, 2019. As of September 30, 2017 and December 31, 2016, the total notional amount of the Company's interest rate swaps were $50 million.

The fair value of the interest rate swap will be included in other long term assets or liabilities, when applicable. As of September 30, 2017 and December 31, 2016, the fair value of the interest rate swap was not considered to be significant due to the change in LIBOR over that time period outstanding, therefore, no amount is included on the balance sheet for this instrument. As the specific terms and notional amounts of the derivative financial instrument match those of the fixed-rate debt being hedged, the derivative instruments are assumed to be perfectly effective hedges and accordingly, there is no impact to the Company's consolidated statements of operations. Gains and losses on this interest rate swap agreement will be recorded in accumulated other comprehensive income and will be reclassified to interest expense in the period during which the hedged transaction affects earnings. At September 30, 2017 and December 31, 2016, there was no impact to accumulated other comprehensive income (AOCI) as it was determined that there was not a significant change to record. The fair value of this instrument will be evaluated on a quarterly basis and adjusted as necessary.

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Note F – Class A Redeemable Convertible Preferred Stock

On December 30, 2015, NeoGenomics issued 14,666,667 shares of its Series A Preferred stock as part of the consideration for the acquisition of Clarient. The Series A Preferred Stock has a face value of $7.50 per share for a total liquidation value of $110 million. During the first year, the Series A Preferred Stock had a liquidation value of $100 million if the shares were redeemed prior to December 29, 2016. On December 22, 2016, the Company redeemed 8,066,667 shares of the Series A Preferred Stock for $55.0 million in cash. The redemption amount per share equaled $6.8181825 ($7.50 minus the liquidation discount of 9.0909%). At September 30, 2017, 6,600,000 shares of Series A Preferred Stock were outstanding.

The carrying amount of the Series A Preferred Stock at September 30, 2017 was $30.1 million as compared to the carrying amount at December 31, 2016 of $22.9 million. The increase in the carrying amount is due to the accrual of deemed dividends of approximately $2.7 million, the accretion of the beneficial conversion feature of approximately $5.1 million during the nine months ending September 30, 2017 and the additional BCF discounts for payment-in-kind shares accrued during the nine months ending September 30, 2017 of $0.6 million. Both the deemed dividends and the accretion of the beneficial conversion feature are recorded as distributions to the holders of the Series A Preferred Stock on the income statement with the corresponding entry recorded as an increase to the carrying value of the Series A Preferred Stock.

Issue Discount

The Company recorded the Series A Preferred Stock at a fair value of approximately $73.2 million or $4.99 per share on the date of issuance. The difference between the fair value of $73.2 million and the liquidation value of $110 million represents a discount of $36.8 million from the initial face value as a result of assessing the impact the rights and features of the instrument and their effect on the value to the Company. After the partial redemption, the Series A Preferred stock has a fair value of approximately $32.9 million or $4.99 per share. The difference between the fair value of $32.9 million and the liquidation value of $49.5 million represents a discount of approximately $16.6 million.

Beneficial Conversion Features

The fair value of the common stock into which the Series A Preferred Stock is convertible exceeded the allocated purchase price fair value of the Series A Preferred Stock at the date of issuance and after redemption by approximately $44.7 and $20.1 million, respectively, resulting in a beneficial conversion feature. The Company will recognize the beneficial conversion feature as non-cash, deemed dividend to the holder of Series A Preferred Stock over the first three years the Series A Preferred Stock is outstanding, as the date the stock first becomes convertible is three years from the issue date. The amount recognized for the three and nine months ended September 30, 2017 was approximately $1.7 million and $5.1 million, respectively.

In addition to the beneficial conversion feature ("BCF") recorded at the original issue date, we recorded additional BCF discounts for payment-in-kind shares accrued for quarters ended March 31, 2017, June 30, 2017 and September 30, 2017, as dividends. After the early redemption, the face value of the remaining Series A Preferred Stock is $49.5 million. We will issue 264,000 additional shares ($49.5 million * 4.0%) / $7.50) of Series A Preferred Stock as payment-in-kind dividends for the year ending December 31, 2017, the first year dividends are payable. The additional 264,000 shares will be discounted and amortized to the income statement over the remaining period up to the earliest conversion date, which is three years from the original issue date. The additional BCF discount recorded for the three and nine months ended September 30, 2017 was approximately $201,240 and $603,720 respectively.

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Automatic Conversion

Each share of Series A Preferred Stock issued and outstanding as of the tenth anniversary of the original issue date will automatically convert into fully paid and non-assessable shares of common stock.

Classification

The Company classified the Series A Preferred Stock as temporary equity on the consolidated balance sheets due to certain change in control events that are outside the Company's control, including deemed liquidation events described in the Series A Certificate of Designation.

Note G – Revenue Recognition and Contractual Adjustments

The Company recognizes revenues when (a) the price is fixed or determinable, (b) persuasive evidence of an arrangement exists, (c) the service is performed and (d) collectability of the resulting receivable is reasonably assured. The Company's specialized diagnostic services are performed based on a written test requisition form or electronic equivalent, and revenues are recognized once the diagnostic services have been performed, and the results have been delivered to the ordering physician. These diagnostic services are billed to various payers, including Medicare, commercial insurance companies, other directly billed healthcare institutions such as hospitals and clinics, and individuals. The Company reports revenues from contracted payers, including Medicare, certain insurance companies and certain healthcare institutions, based on the contractual rate, or in the case of Medicare, published fee schedules. The Company reports revenues from non-contracted payers, including certain insurance companies and individuals, based on the amount expected to be collected. The difference between the amount billed and the amount estimated to be collected from non-contracted payers is recorded as an allowance to arrive at the reported net revenues. The expected revenues from non-contracted payers are based on the historical collection experience of each payer or payer group, as appropriate. The Company records revenues from patient pay tests net of a large discount and as a result recognizes minimal revenue on those tests. The Company regularly reviews its historical collection experience for non-contracted payers and adjusts its expected revenues for current and subsequent periods accordingly. On January 1, 2017, we had a significant reduction in our patient fee schedule that primarily impacts the amount billed to uninsured patients.

The table below shows the adjustments made to gross service revenues to arrive at net revenues (in thousands), the amount reported on our statements of operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Gross service revenues	$85,429	$114,902	$263,229	$376,857
Total contractual adjustments and discounts	(22,377)	(54,141)	(72,411)	(193,264)
Net revenues	$63,052	$60,761	$190,818	$183,593

Note H – Equity

A summary of the stock option activity under the Company's plans for the three months ended September 30, 2017 is as follows:

	Number of shares	Weighted average exercise price
Options outstanding at December 31, 2016	5,136,110	$ 5.76
Options granted	2,070,498	7.56
Less:		
Options exercised	503,320	3.73
Options canceled or expired	210,347	5.80
Options outstanding at September 30, 2017	6,492,941	6.47
Exercisable at September 30, 2017	2,137,259	5.47

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Of the 6,492,941 outstanding options at September 30, 2017, 1,240,834 were variable accounted stock options issued to non-employees of the Company of which 445,833 options were vested and 795,001 options were unvested as of September 30, 2017.

The fair value of each stock option award granted during the nine months ended September 30, 2017 was estimated as of the grant date using a trinomial lattice model with the following weighted average assumptions:

	Nine Months Ended September 30, 2017
Expected term (in years)	3.0 - 4.5
Risk-free interest rate (%)	1.5%
Expected volatility (%)	43.5% - 53.0%
Dividend yield (%)	0.0%
Weighted average fair value/share at grant date	$ 2.24

As of September 30, 2017, there was approximately $6.5 million of unrecognized share based compensation expense related to stock options that will be recognized over a weighted-average period of approximately 1.3 years. This includes approximately $1.9 million in unrecognized expense related to the 795,001 shares of unvested variable accounted for stock options subject to fair value adjustment at the end of each reporting period based on changes in the Company’s stock price.

Stock based compensation expense recognized for stock options and restricted stock and included in the consolidated statements of operations was allocated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Research and development expense	$531	$187	$858	$550
General and administrative expense	2,229	1,499	4,954	3,484
Total stock based compensation expense	$2,760	$1,686	$5,812	$4,034

Stock based compensation recorded in research and development relates to unvested options granted to a non-employee.

Common Stock Warrants

A summary of the warrant activity for the six months ended September 30, 2017 is as follows:

	Number of shares	Weighted average exercise price
Warrants outstanding at December 31, 2016	450,000	$ 1.49
Warrants granted	—	—
Less:		
Warrants exercised	450,000	1.49
Warrants canceled or expired	—	—
Warrants outstanding at September 30, 2017	—	—
Exercisable at September 30, 2017	—	—

During both the three months ended September 30, 2017 and 2016, we recorded $0 of warrant compensation expense. During the nine months ended September 30, 2017, we recorded $0 of warrant compensation expense and during the nine months ended September 30, 2016 we recorded a warrant compensation gain of approximately $10,000, respectively. Warrant expense (gain) for the periods presented is recorded in research and development as the expense is related to unvested performance based warrants that were granted to a non-employee. As of September 30, 2017, there were no outstanding warrants.

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Restricted Stock

On August 31, 2017, we issued 450,000 shares of restricted common stock to Ascend Genomics as purchase consideration for the customer list acquired. The customer list was recorded as an intangible asset, see Note C – Goodwill and Intangible Assets. As a condition of the purchase, Ascend is prohibited from trading the shares for a period of six months from the closing date.

Employee Stock Purchase Plan

We offer an employee stock purchase plan ("ESPP") through which eligible employees may purchase shares of our common stock at a discount. On May 25, 2017, the Company amended the ESPP, increasing the discount from 5% to 15% of the fair market value of the Company's common stock. As a result of this change, we have recorded stock based compensation expense related to the ESPP for the quarter ended September 30, 2017.

During the three months ended September 30, 2017 and 2016, employees purchased 23,664 and 26,092 shares, respectively under the ESPP. The expense recorded for these periods was $41,907 and $0, respectively. During the nine months ended September 30, 2017 and 2016, employees purchased 74,756 and 75,623 shares, respectively under the ESPP. The expense recorded for these periods was $41,907 and $0.

Note I – Commitments

During the three and nine months ended September 30, 2017, the Company entered into leases of approximately $683,000 and $3.2 million in laboratory and computer equipment, respectively. These leases have 36 month terms, a $1.00 buyout option at the end of the terms and interest rates ranging from 0.0% to 19.5%. The Company accounted for these lease agreements as capital leases.

During the nine months ended September 30, 2017, the Company entered into a construction contract for the expansion of our laboratory in Houston, Texas. The contract is for approximately $5.0 million, which the Company intends to finance through a capital lease with a 36 month term and a $1.00 buyout option. The interest rate under this lease will vary based on the timing of the construction payments. We anticipate this project to be complete in the first quarter of 2018.

Note J – Other Related Party Transaction

During each of the three and nine month periods ended September 30, 2017 and 2016, Steven C. Jones was an officer, director and shareholder of the Company. In connection with his duties as Executive Vice President, Mr. Jones earned approximately $46,000 and $66,000 for the three months ended September 30, 2017 and 2016, respectively. In addition, as compensation for his services on the Board, Mr. Jones earned approximately $13,000 and $0 for the three months ended September 30, 2017 and 2016, respectively. During the nine months ended September 30, 2017 and 2016, Mr. Jones earned approximately $164,000 and $197,000, respectively in connection with his duties as Executive Vice President. Mr. Jones also received approximately $85,000 and $79,000 during the nine months ended September 30, 2017 and 2016, respectively, as payment of his annual bonus compensation for the previous fiscal years. In addition, as compensation for his services on the Board, Mr. Jones earned $25,500 and $0 for the nine months ended September 30, 2017 and 2016, respectively.

During each of the three and nine month periods ending September 30, 2017 and 2016, Kevin Johnson was a director and shareholder of the Company. In May of 2017, the Company engaged Mr. Johnson to provide services as a consultant. This engagement ended in June of 2017. In connection with his role as a consultant, Mr. Johnson earned approximately $0 and $0 for the three months ended September 30, 2017 and 2016, respectively. In addition, as compensation for his services on the Board, Mr. Johnson earned approximately $14,000 and $15,000, for the three months ended September 30, 2017 and 2016, respectively and approximately $44,000 and $45,000 for the nine months ended September 30, 2017 and 2016, respectively.

On May 25, 2017, the Company granted stock options and restricted stock to each of its board members as part of its annual board compensation process. Mr. Jones and Mr. Johnson were each granted 10,000 stock options and 8,667 shares of restricted stock for their Board services. The options were granted at a price of $7.27 per share and had a weighted average fair market value of $2.38 per option. The options vest ratably over the next three years. The restricted stock has a weighted average fair value of $7.27 per share and vests ratably on the last day of each calendar quarter up to March 31, 2018.

END OF FINANCIAL STATEMENTS

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NeoGenomics, Inc., a Nevada corporation (referred to collectively with its subsidiaries as "NeoGenomics", "we", "us", "our" or the "Company" in this Form 10-K) is the registrant for SEC reporting purposes. Our common stock is listed on the NASDAQ Capital Market under the symbol "NEO".

Introduction

The following discussion and analysis should be read in conjunction with the unaudited consolidated financial statements, and the notes thereto included herein. The information contained below includes statements of the Company's or management's beliefs, expectations, hopes, goals and plans that, if not historical, are forward-looking statements subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. For a discussion on forward-looking statements, see the information set forth in the introductory note to this quarterly report on Form 10-Q under the caption "Forward-Looking Statements", which information is incorporated herein by reference.

Overview

We operate a network of cancer-focused genetic testing laboratories in the United States. Our mission is to improve patient care through exceptional genetic and molecular testing services. Our vision is to become the World's leading cancer testing and information company by delivering uncompromising quality, exceptional service and innovative solutions.

As of September 30, 2017, the Company had laboratory locations in Aliso Viejo and Fresno, CA; Tampa and Fort Myers, FL; Houston, TX and Nashville, TN. The Company currently offers the following types of genetic and molecular testing services:

a) Cytogenetics - the study of normal and abnormal chromosomes and their relationship to disease. It involves looking at the chromosome structure to identify changes from patterns seen in normal chromosomes. Cytogenetic studies are often utilized to answer diagnostic, prognostic and predictive questions in the treatment of hematological malignancies.
b) Fluorescence In-Situ Hybridization ("FISH") - a branch of cancer genetics that focuses on detecting and locating the presence or absence of specific DNA sequences and genes on chromosomes. FISH helps bridge abnormality detection between the chromosomal and DNA sequence levels. The technique uses fluorescent probes that bind to only those parts of the chromosome with which they show a high degree of sequence similarity. Fluorescence microscopy is used to visualize the fluorescent probes bound to the chromosomes. FISH can be used to help identify a number of gene alternations, such as amplification, deletions, and translocations.
c) Flow cytometry - a rapid way to measure the characteristics of cell populations. Cells from peripheral blood, bone marrow aspirate, lymph nodes, and other areas are labeled with selective fluorescent antibodies and analyzed as they flow in a fluid stream through a beam of light. The properties measured in these antibodies include the relative size, relative granularity or internal complexity, and relative fluorescence intensity. These fluorescent antibodies bind to specific cell surface antigens and are used to identify malignant cell populations. Flow cytometry is typically performed in diagnosing a wide variety of leukemia and lymphoma neoplasms. Flow cytometry is also used to monitor patients through therapy to determine whether the disease burden is increasing or decreasing, otherwise known as minimal residual disease monitoring.
d)

Immunohistochemistry (“IHC”) and Digital Imaging – Refers to the process of localizing proteins in cells of a tissue section and relies on the principle of antibodies binding specifically to antigens in biological tissues. IHC is widely used in the diagnosis of abnormal cells such as those found in cancerous tumors. Specific surface cytoplasmic or nuclear markers are characteristic of cellular events such as proliferation or cell death (apoptosis). IHC is also widely used to understand the distribution and localization of differentially expressed proteins. Digital imaging allows clients to see and utilize scanned slides and perform quantitative analysis for certain stains. Scanned slides are received online in real time and can be previewed often a full day before the glass slides can be shipped back to clients.

e) Molecular testing - a rapidly growing cancer testing methodology that focuses on the analysis of DNA and RNA, as well as the structure and function of genes at the molecular level. Molecular testing employs multiple technologies including DNA fragment length analysis, real-time polymerase chain reaction (“RT-PCR”) RNA analysis, bi-directional Sanger sequencing analysis, and Next-Generation Sequencing (“NGS”).

f) Pathology consultation - services provided to clients whereby our pathologists review surgical samples on a consultative basis. NeoGenomics pathologists are some of the foremost experts on pathology in the country, and are used as experts on difficult and challenging cases.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Clinical Cancer Testing Services

The cancer testing services we offer to community-based pathologists are designed to be a natural extension of, and complementary to, the services that they perform within their own practices. We believe our relationship as a non-competitive partner to community-based pathology practices, hospital pathology labs and academic centers empowers them to expand their breadth of testing and provide a menu of services that matches or exceeds the level of service found in any center of excellence around the world.

Pharma Services and Clinical Trials

Our Pharma Services division supports pharmaceutical firms in their drug development programs by supporting various clinical trials. This portion of our business often involves working with the pharmaceutical firms (sponsors) on study design as well as performing the required testing. Our medical team often advises the sponsor and works closely with them as specimens are received from the enrolled sites. We also work on developing tests that will be used as part of a companion diagnostic to determine patients' response to a particular drug. As studies unfold, our clinical trials team reports the data and often provide key analysis and insights back to the sponsors.

Our Pharma Services and Clinical Trials group provides comprehensive testing services in support of our pharmaceutical clients' oncology programs from discovery to commercialization. In biomarker discovery, our aim is to help our customers discover the right content. We help our customers develop a biomarker hypothesis by recommending an optimal platform for molecular screening and backing our discovery tools with the informatics to capture meaningful data. In other pre and non-clinical work, we can use our platforms to characterize markers of interest. Moving from discovery to development, we help our customers refine their biomarker strategy and, if applicable, develop a companion diagnostic pathway using the optimal technology for large-scale clinical trial testing.

Whether serving as the single contract research organization or partnering with one, our Pharma Services and Clinical Trials team provides significant technical expertise working closely with our customers to support each stage of clinical trial development. Each trial we support comes with rapid turnaround time, dedicated project management and quality assurance oversight. We have experience in supporting submissions to the Federal Drug Administration for companion diagnostics. Our Pharma Services strategy is focused on helping bring more effective oncology treatments to market through providing world class laboratory services in oncology to key pharmaceutical companies in the industry.

2017 Focus Areas: Develop High Performance Culture, Inspire & "Own" Quality, Accelerate Growth and Advance Our Strategy

Over the past several years, NeoGenomics has experienced rapid growth including organic growth from offering new tests to existing customers, growth from gaining market share from our competitors, and growth from acquisitions. We expect to continue to grow our business in 2017 and are focused on several initiatives to continue to build our Company to be the World's leading cancer testing and information company.

Develop our High Performance Culture

We are building our high performance culture by empowering our employees and investing in their growth. We are providing skill based training, education, and mentoring our supervisors and managers to allow them to grow within the Company. We communicated career opportunities and performance objectives and hold each employee accountable for their own development. Teamwork is highly encouraged through the use of team performance incentive plans as well as other meaningful recognition and rewards. To cultivate teamwork we are committed to improving communication by providing better tools for today's connected society. Our organization uses weekly employee surveys and takes actions based on the feedback from those surveys. We believe that a culture of engaged employees provides superior service to our clients and their patients battling cancer. We have employee retention targets that are set each year, and we believe our employee retention rate is above average for the laboratory industry. Recruiting and retaining talented employees is critical in the fast moving field of cancer diagnostics.

Inspire and "Own" Quality

Since the acquisition of Clarient, Inc. and its wholly owned subsidiary Clarient Diagnostic Services, Inc. (together "Clarient") we've focused on combining the very best of both NeoGenomics and Clarient testing menus and services. We've had functional teams work through every part of the business to ensure that we were able to maintain our high level of quality and create best practices

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throughout our organization. Maintaining quality laboratory operations and service is enabling us to retain existing clients while adding new ones.

We have a variety of initiatives designed to further enhance our company-wide quality program, provide training on the importance of quality, reinforce our quality principals, and recognize individuals and teams for providing quality service. By promoting and reinforcing quality principles, we believe we can strengthen our core processes. Our focus on continuous improvement, first time quality and the work of our best-practice teams will enable us to continue reducing our cost per test as we have steadily over the past several years.

In 2016, we began work on our next generation Laboratory Information System ("LIS") and our information technology team is working to complete the LIS for certain key areas of our Pharma Services division in 2017. We believe the new LIS will help to drive improvements in several laboratory areas and will allow for further automation and operational efficiencies. The new LIS will also meet the stringent requirements of our Pharma Services clients and will enable these clients the ability to track each step through the laboratory process. On June 30, 2017, we began using this new system in certain areas of our Pharma Services business and we will continue to roll it out. Once all of the Pharma Services testing is on the new LIS, we intend to begin using it in our Clinical Testing division.

We have renovated our Aliso Viejo, CA laboratory and are currently working on the expansion of our Houston, TX facility which we expect to complete by the end of the first quarter of 2018. We completed the consolidation of our Irvine Lab facility into the Aliso Viejo Lab facility, and we fully vacated the Irvine facility on April 30, 2017. We have also completed the sale of PathLogic on August 1, 2017 and therefore no longer have a laboratory in West Sacramento, CA. We expect these changes in our business to result in additional capacity, economies of scale and operating efficiencies.

Accelerate Profitable Growth

Our plans for 2017 include many initiatives to continue our strong organic growth by gaining market share, introducing new tests, and expanding our Pharma business. Through the acquisition of Clarient we have significantly expanded our Pharma Services business, and plan to develop it further by creating an international presence and incorporating new technologies. Also, as a result of the Clarient acquisition, we have expanded our sales team and now offer our services in geographic areas where we did not previously have sales representation. We believe our highly trained sales team has been successful in competing against other laboratories because of our exceptional service levels, and because we have one of the broadest and most comprehensive test menus in our industry. Our broad menu of molecular and immunohistochemistry testing has helped make us a "one stop shop" for many clients who like the fact that all of their testing can be sent to one laboratory.

We currently perform comprehensive analyses for hematopoietic cancers such as leukemia and lymphoma (blood and lymphoid tumors) as well as solid tumors such as breast, lung, colon, and bladder cancers. Our sales team is experienced with the scientific complexity and medical necessity of our testing services, and understands the needs of our client pathologists and oncologists. We will continue to pursue market share gains by providing high complexity, cancer-related laboratory testing services to hospitals, community-based pathology practices, academic centers, and clinicians throughout the United States.

Our growth has also been aided by strong client retention. We believe our client retention success is due to our strong service levels, our tech-only service offerings, and a culture of customer focus in which our engaged employees seek to deliver highest customer satisfaction possible. Our strong service levels are reinforced by a disciplined management process with a system of detailed measures and metrics to ensure committed turnaround times and customer service. Our broad menu of molecular and immunohistochemistry testing has helped make us a “one stop shop” for many clients who like the fact that all of their testing can be sent to one laboratory.

In early 2017, we re-branded and created a new logo. We intend to implement strategic marketing plans to further develop our brand and build brand awareness. We have re-designed our trade show booth incorporating our new logo and plan to improve new test launches by using social media to improve brand awareness. We believe by executing and developing our brand we will achieve growth in new and existing markets.

We also look for opportunities to grow our business through mergers and/or acquisitions. We are focused on strategic opportunities that would be complementary to our menu of services and would increase our earnings and cash flow in the short to medium timeframe. In late 2015 we acquired Clarient which specialized in advanced oncology diagnostic services, this acquisition has enabled NeoGenomics to

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broaden its offering of innovative cancer diagnostic tests to hospitals and physicians across the country, and to accelerate its growth in the fast-growing worldwide market for pharmaceutical clinical trials and research. Complementary product offerings and expanded geographical reach of the combined Company will provide customers with substantial benefits and create a significantly larger and more diversified provider of precision oncology diagnostics. The Clarient transaction is a good example of the type of acquisition opportunity we will consider in the future.

Advance Our Strategy

We are committed to being an innovative leader and believe this has been and will be a key factor in our growth. We plan to accomplish this goal through strategic actions designed to: 1) advance the technology we use in our laboratories, 2) evaluate, develop and deploy new products and services, and 3) evaluate and experiment with value-based payment models in collaboration with oncology groups and other health care providers.

Our broad and innovative testing menu allows us to serve community-based pathologists and clinicians as well as pharmaceutical customers and nationally recognized academic centers. Over the past year, we have developed approximately 50 new molecular oncology tests and disease-specific panels, and we believe we have one of the most comprehensive oncology test menus of any laboratory in the world. By launching new medically significant and necessary tests at a steady rate, we are able to provide cutting-edge developments in molecular genetics with clients and their patients and are developing our reputation as a leader in the field of molecular oncology. In many cases, customers who begin using us because of our new innovative test offerings also begin to refer portions of their other testing.

Our comprehensive test offering allows us to be a one-stop shop for all of the oncology testing needs of our clients. Pharmaceutical firms are also attracted to our laboratory based on extensive test menu, and based on our knowledgeable research and development team as well as our ability to offer tests at the forefront of medical developments.

We continue to pursue opportunities to offer "liquid biopsy" testing, particularly for hematological diseases. We have launched twelve NEOLAB™ liquid biopsy tests for hematological disease using next generation sequencing and other advanced molecular technologies. Liquid Biopsy testing uses cell-free circulating DNA and RNA found in blood plasma to identify molecular abnormalities in the bone marrow without the need for a bone marrow biopsy. The technology is based on the concept that hematologic cells release their DNA, RNA, and protein into circulation as the cells are immersed in blood. The cell-free circulating DNA, RNA and protein are referred to as exosomes, microvesicles, apoptotic bodies or simply DNA- or RNA-protein complexes. Our new tests use proprietary methods to extract these circulating nucleic acids and analyze them using next generation sequencing and advanced methods in order to evaluate molecular abnormalities present in hematological cancers.

We also continue to develop new testing approaches by combining the capabilities of a variety of testing technologies. Our NeoTYPE™ multimodality testing is somewhat unique in the industry and combines immunohistochemistry testing, molecular testing, and FISH testing into disease-specific panels that are very effective and efficient for improving patient care. We introduced a number of NeoTYPE™ molecular panels that combine multiple molecular tests into multi-gene panels targeting specific types of cancer to help pathologists and oncologists determine cancer subtypes on difficult cases. Managed care payers have expressed interest in the more targeted panels

as a more cost effective alternative to ordering large whole genome panels that include genes that have never been tied to a particular type of cancer.

Our NeoLAB (Liquid Biopsy) Prostate cancer test which is performed on blood plasma and urine rather than on prostate tissue biopsies is currently available as a Laboratory Developed Test and we have received clinical orders for it. There are two goals for this test: 1) to diagnose the presence of cancer in patients and 2) to distinguish high-grade from low-grade cancer in patients with prostate cancer. We are working to gain reimbursement for this test which we believe could significantly increase the acceptance and the number of test orders we receive for this important test.

Competitive Strengths

Turnaround Times

We strive to provide industry leading turnaround times for test results to our clients nationwide. By providing information to our clients in a rapid manner, physicians can begin treating their patients as soon as possible. We believe our average 4-5 day turnaround

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time for our cytogenetics testing services, our average 3-4 day turnaround time for FISH testing services, our 5-7 day turnaround time for molecular testing and our average 1 day turnaround time for flow cytometry and pathology testing services are industry-leading benchmarks for national laboratories. Our consistent timeliness of results is a competitive strength and a driver of additional testing requests by our referring physicians. Rapid turnaround times allow for the performance of other adjunctive tests within an acceptable diagnosis window in order to augment or confirm results and more fully inform treatment options. We believe that our fast turnaround times are a key differentiator versus other national laboratories, and our clients often cite them as a key factor in their relationship with us.

World-class Medical and Scientific Team

Our team of medical professionals and Ph.Ds. are specialists in the field of genetics, oncology and pathology. As of September 30, 2017, we employed, or are contracted with, approximately 28 full-time M.D.s and Ph.Ds. The addition of Clarient's pathology team has added increased depth to our medical team, and has enhanced our ability to service a wider range of specialties.

Extensive Tech-Only Service Offerings

We currently have the most extensive menu of tech-only FISH services in the country as well as extensive and advanced tech-only flow cytometry and IHC testing services. These types of testing services allow the professional interpretation component of a test to be performed and billed separately by our physician clients. Our FISH, flow cytometry and other tech-only service offerings allow properly trained and credentialed community-based pathologists to extend their own practices by performing professional interpretations services, which allows them to better service the needs of their local clientele without the need to invest in the lab equipment and personnel required to perform the technical component of genetic and molecular testing.

Our tech-only services are designed to give pathologists the option to choose, on a case by case basis, whether they want to order just the technical information and images relating to a specific test so they can perform the professional interpretation, or order "global" services and receive a comprehensive test report which includes a NeoGenomics Pathologist's interpretation of the test results. Our clients appreciate the flexibility to access NeoGenomics' medical staff for difficult or complex cases or when they are otherwise unavailable to perform professional interpretations. We believe this innovative approach to serving the needs of pathology clients' results in longer term, more committed client relationships that are, in effect, strategic partnerships. Our extensive tech-only service offerings have differentiated us and allowed us to compete more effectively against larger, more entrenched competitors in our niche of the industry.

Global Service Offerings

We offer a comprehensive suite of technical and interpretation services, to meet the needs of those clients who are not credentialed and trained in interpreting genetic tests and who require pathology specialists to interpret the testing results for them. In our global service offerings, our lab performs the technical component of the tests and our M.D.s and Ph.Ds. provide the service of interpreting the results of those tests. Our professional staff is also available for post-test consultative services. Clients using our global service offering rely on the expertise of our medical team to give them the answers they need in a timely manner to help inform their diagnoses and treatment decisions. Many of

our tech-only clients also rely on our medical team for difficult or challenging cases by ordering our global testing services on a case-by-case basis or our medical team can serve as a backup to support our clients who need help to satisfy the continued and demanding requirements of their practice. Our reporting capabilities allow for all relevant case data from our global services to be captured in one summary report. When providing global services, NeoGenomics bills for both the technical and professional component of the test, which results in a higher reimbursement level.

Client Education Programs

We believe we have one of the most extensive client education programs in the genetic and molecular testing industry. We train pathologists how to use and interpret genetic testing services so that they can better interpret technical data and render their diagnosis.

Our educational programs include an extensive library of on-demand training modules, online courses, webinars and custom tailored on-site training programs that are designed to prepare clients to utilize our tech-only services. We offer training and information on new cancer tests and the latest developments in the field of molecular genetic testing. Each year, we also regularly sponsor seminars and webinars on emerging topics of interest in our field. Our medical staff is involved in many aspects of our training programs.

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Superior Testing Technologies and Instrumentation

We use some of the most advanced testing technologies and instrumentation in the laboratory industry. The use of next generation sequencing in our molecular testing allows us to detect multiple mutations and our proprietary techniques allow us to achieve high sensitivity in our next generation sequencing testing. In addition, we use high sensitivity Sanger sequencing, RNA and DNA quantification, SNP/Cytogenetic arrays, Fragment Length analysis, and other molecular testing technologies. Our automated FISH and Cytogenetics tools allow us to deliver the highest quality testing to our clients and our flow cytometry laboratory uses 10-color flow cytometry analysis technology on a technical-only basis. NeoGenomics is continually testing new laboratory equipment in order to remain at the forefront of new developments in the testing field.

Laboratory Information System

We believe we have a state-of-the-art LIS that interconnects our locations and provides flexible reporting solutions to clients. This system allows us to standardize testing and deliver uniform test results and images throughout our network, regardless of the location that any specific portion of a test is performed within our network. This allows us to move specimens and image analysis work between locations to better balance our workload. Our LIS also allows us to offer highly specialized and customizable reporting solutions to our tech-only clients. For instance, our tech-only FISH and flow cytometry applications allow our community-based pathologist clients to tailor individual reports to their specifications and incorporate only the images they select and then issue and sign-out such reports using our system. Our customized reporting solution also allows our clients to incorporate test results performed on ancillary tests not performed at NeoGenomics into summary report templates. This FlexREPORT feature has been well-received by clients.

National Direct Sales Force

Our direct sales force has been trained extensively in cancer genetic testing and consultative selling skills to service the needs of clients. Our sales team for the clinical cancer testing services is organized into five regions (Northeast, Southeast, North Central, South Central and West), and we have a separate sales team for our Pharma Services division. These sales representatives utilize our custom Customer Relationship Management System ("CRM") to manage their territories, and we have integrated all of the important customer care functionality within our LIS into the CRM so that our sales representatives can stay informed of emerging issues and opportunities within their regions. Our in-house customer care team is aligned with our field sales team to serve the needs of our clients by utilizing the same LIS and CRM. Our field teams can see in real-time when a client calls the laboratory, the reason for the call, the resolution, and if face-to-face interaction is needed for follow-up.

Geographic Locations

Many high complexity laboratories within the cancer testing niche have frequently operated a core facility on either the West Coast or the East Coast of the United States to service the needs of their customers around the country. We believe our clients and prospects desire to do business with a laboratory with national breadth and a local presence. We have six facilities including three large laboratory locations in Fort Myers, Florida, Aliso Viejo, California and Houston Texas. We also have three smaller laboratory locations in Fresno, California, Nashville, Tennessee and Tampa, Florida. Our objective is to "operate one lab with multiple locations" in order to deliver standardized, high

quality, test results. We have completed renovations in our Aliso Viejo facility and have successfully transitioned all Irvine employees and tests into the much larger Aliso Viejo laboratory during late March 2017. We are also working to expand our Houston, Texas facility in order to increase capacity and plan to complete this expansion by the end of the first quarter of 2018. In addition, our new lab in Geneva, Switzerland is fully operational with a grand opening planned for early November of 2017. We intend to continue to develop and open new laboratories and/or expand our current facilities as market situations dictate and business opportunities arise.

Scientific Pipeline

In the past few years our field has experienced a rapid increase in tests that are tied to specific genomic pathways. These predictive tests are typically individualized for a small sub-set of patients with a specific subtype of cancer. The therapeutic target in the genomic pathway is typically a small molecule found at the level of the cell surface, within the cytoplasm and/or within the nucleus. These genomic pathways, known as the “Hallmarks of Cancer”, contain a target-rich environment for small-molecule anti-therapies. These anti-therapies target specific mutations in the major cancer pathways such as the Proliferation Pathway, the Apoptotic Pathway, the Angiogenic Pathway, the Metastasis Pathway, and the Signaling Pathways and Anti-Signaling Pathways.

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Seasonality

The majority of our testing volume is dependent on patients being treated by hematology/oncology professionals and other healthcare providers. The volume of our testing services generally declines modestly during the summer vacation season, year-end holiday periods and other major holidays, particularly when those holidays fall during the middle of the week. In addition, the volume of our testing tends to decline due to extreme adverse weather conditions, such as excessively hot or cold spells, heavy snow, hurricanes or tornados in certain regions, consequently reducing revenues and cash flows in any affected period. During the third quarter of 2017, Hurricane Harvey forced the closure of our Houston laboratory for three days and Hurricane Irma forced the closure of our Fort Myers facility for five days. Therefore, comparison of the results of successive periods may not accurately reflect trends for future periods.

Please see the section captioned Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2016; as filed with the SEC on March 14, 2017 for a detailed description of our business.

Results of Operations for the Three and Nine Months Ended September 30, 2017 as Compared to the Three and Nine Months Ended September 30, 2016

The following table presents the consolidated statements of operations as a percentage of revenue:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2017	2016	2017	2016
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	54.3 %	55.0 %	54.3 %	54.7 %
Gross Profit	45.7 %	45.0 %	45.7 %	45.3 %
Operating expenses:				
General and administrative	36.9 %	31.3 %	35.0 %	30.4 %
Research and development	2.0 %	1.6 %	1.6 %	2.0 %
Sales and marketing	10.4 %	9.8 %	9.7 %	9.9 %
Loss on sale of Path Logic	1.7 %	—	0.6 %	—
Total operating expenses	51.0 %	42.7 %	46.9 %	42.3 %
Income (loss) from operations	(5.3)%	2.3 %	(1.2)%	3.0 %
Interest expense, net	2.2 %	2.4 %	2.2 %	2.5 %
Net income (loss) before income taxes	(7.5)%	(0.1)%	(3.4)%	0.5 %
Income tax (benefit) expense	0.5 %	0.0 %	(0.3)%	0.3 %
Net income (loss)	(8.0)%	(0.1)%	(3.1)%	0.2 %

The following table presents consolidated net revenue by type for the periods indicated ($ in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2017	2016	$ Change	% Change	2017	2016	$ Change	% Change
Clinical testing	$56,186	$55,739	$ 447	1 %	$172,668	$166,674	$ 5,994	4 %
Pharma Services	6,866	5,022	1,844	37 %	18,150	16,919	1,231	7 %
Total Revenue	$63,052	$60,761	$ 2,291	4 %	$190,818	$183,593	$ 7,225	4 %

Revenue

Clinical testing revenue increased for both the three and nine month periods ending September 30, 2017 as compared to the same periods in 2016. Testing volumes also increased in our clinical genetic testing business by approximately 16.6% and 16.0% for the three and nine month periods ended September 30, 2017, respectively. The increases in revenue and volume were due to strong growth in molecular and histology testing as well as growth in immuno-histochemistry tests due to demand for the PD-L1 test as a result of the FDA approving Pembrolizumab (Keytruda) in October 2016 as first-line treatment for PD-L1 positive non-small cell lung cancer. We have also seen accelerating growth in flow cytometry and FISH. While revenues and volumes increased quarter over quarter and year over year, we believe the impact of hurricanes Harvey and Irma depressed our revenues by approximately $1.0 million and volumes by approximately 1.5% during the third quarter of 2017. Our sales team has largely finished integration related

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activities, which was a distraction from their efforts to sell new business. We believe the team can now be re-focused on growth and selling the benefits of the combined company.

Pharma Services revenue increased approximately 37% and 7% for the three and nine month periods ended September 30, 2017 as compared to the same periods in 2016. In addition, our backlog of signed contracts has continued to grow from $46.5 million as of June 30, 2017 to $58.0 million as of September 30, 2017. We expect this backlog to result in higher revenues in future quarters. We also expect to see growth in our Pharma Services division due to our international expansion into Geneva, Switzerland. This facility will be operational in the fourth quarter of 2017 and already has a backlog of approximately $1.5 million.

Revenue was also impacted due to an error that we identified during an internal analysis in the third quarter of 2017. The error impacted revenue reported in our Form 10-K for the year ended December 31, 2016, Form 10-Q for the quarter ended March 31, 2017 and Form 10-Q for the quarter ended June 30, 2017. Specifically, we determined that certain unbillable tests were inadvertently included in the revenue accrual recorded for these periods. The Company assessed the extent of this error and it was corrected in the third quarter of 2017, resulting in an understatement of revenue of $2.4 million and $0.6 million for the three and nine months ended September 30, 2017, respectively. See Item 4. Controls and Procedures for additional details regarding this error.

The following table shows clinical genetic testing revenue, cost of revenue, requisitions received and tests performed for the three and nine months ended September 30, 2017 and 2016. This data excludes tests performed for Pharma customers and tests performed by Path Logic, which was sold on August 1, 2017. Testing revenue and cost of revenue are presented in thousands below:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	% Change	2017	2016	% Change
Requisitions received (cases)	98,031	90,297	8.6 %	291,806	269,916	8.1 %
Number of tests performed	163,289	140,089	16.6 %	482,476	415,815	16.0 %
Average number of tests/requisition	1.67	1.55	7.4 %	1.65	1.54	7.3 %
Total clinical genetic testing revenue	$55,772	$53,887	3.5 %	$168,999	$160,886	5.0 %
Average revenue/requisition	$568	$597	(4.7 %)	$579	$596	(2.8 %)
Average revenue/test	$342	$385	(11.2 %)	$350	$387	(9.5 %)
Cost of revenue	$29,652	$28,578	3.8 %	$87,889	$85,499	2.8 %
Average cost/requisition	$302	$316	(4.4 %)	$301	$317	(4.9 %)
Average cost/test	$181	$204	(11.0 %)	$182	$206	(11.4 %)

We continue to realize growth in our clinical testing revenue which we believe is the direct result of our efforts to innovate by developing and maintaining one of the most comprehensive cancer testing menus in the industry. Our broad test menu enables our sales teams to identify opportunities for increasing revenues from existing clients and allows us to gain market share from competitors. New immuno-histochemistry tests such as Micro Satellite Instability, DNA Mismatch Repair, PD1 and PD-L1 have continued to show solid growth and have increased our volume and revenue growth in the third quarter. We believe the field of immuno-therapy will continue to show substantial growth in coming years and our ability to offer multi-modality testing in one lab will allow us to capitalize on this increased demand.

Average revenue per test decreased for both the three and nine month periods ended September 30, 2017 as compared to the corresponding periods in the previous year. These decreases are primarily due to the change in test mix, specifically the increase in PD-L1 testing which has a lower average unit price ("AUP") than our overall Company AUP. The 19% Medicare cut in Flow Cytometry reimbursement as a result of the 2017 Medicare Physician Fee Schedule also contributed to the lower revenue per test.

These decreases to our average revenue per test were offset by our higher volumes and reductions in cost per test. The cost per test reductions were partially a result of the change in test mix, specifically the higher mix of lower cost histology tests. In addition, we continue to have success in reducing costs in the laboratory as synergies are being realized from the consolidation of our Irvine and Aliso Viejo, California laboratories. We have also seen a reduction in send-out costs, as our extensive menu makes it rare for us to need to send a test to another laboratory.

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Cost of Revenue and Gross Profit

Cost of revenue includes payroll and payroll related costs for performing tests, maintenance and depreciation of laboratory equipment, rent for laboratory facilities, laboratory reagents, probes and supplies, and delivery and courier costs relating to the transportation of specimens to be tested.

The consolidated cost of revenue and gross profit metrics are as follows ($ in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
Consolidated	2017	2016	$ Change	2017	2016	$ Change
Cost of revenue	$34,242	$33,416	$826	$103,634	$100,471	$3,163
Cost of revenue as a % of revenue	54.3 %	55.0 %		54.3 %	54.7 %	
Gross Profit	$28,810	$27,345	$1,465	$87,184	$83,122	$4,062
Gross Profit Margin	45.7 %	45.0 %		45.7 %	45.3 %	

Consolidated cost of revenue in dollars increased for the three and nine months ended September 30, 2017 when compared to the same periods in 2016 while cost of revenue as a percentage of revenue decreased slightly year-over-year. These increases in cost of revenue are largely due to the increase in our testing volumes and additional costs incurred with the consolidation of our two largest testing facilities in southern California, specifically increased overtime and associated costs.

Gross profit margin increased slightly for both the three and nine months ended September 30, 2017, as compared to the same period last year. These increases were achieved despite the reduction in our revenue per test over these time periods. We were able to increase gross profit margin due to our laboratories processing the increased test volumes more efficiently. We had only limited staffing increases in the laboratory to handle the increased volumes, and our laboratory teams have been extremely focused on reducing their cost per test across all departments. As a result of the correction of the aforementioned error in the third quarter of 2017, gross profit was understated by $2.4 million and $0.6 million for the three and nine months ended September 30, 2017, respectively.

General and Administrative Expenses

General and administrative expenses consist of employee-related costs (salaries, fringe benefits, and stock based compensation expense) for our billing, finance, human resources, information technology and other administrative personnel. We also allocate professional services, facilities expense, IT infrastructure costs, bad debt expense, depreciation, amortization and other administrative-related costs to general and administrative expenses.

Consolidated general and administrative expenses for the periods presented are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
($ in thousands)	2017	2016	2017	2016

			$ Change			$ Change
General and administrative	$23,267	$19,025	$4,242	$66,743	$55,810	$10,933
As a % of revenue	36.9 %	31.3 %		35.0 %	30.4 %	

The increase in our general and administrative expenses for the three and nine months ended September 30, 2017 compared to the same periods in 2016 was largely due to increased expenses in the following areas: bad debt, professional fees and personnel fees (including stock based compensation).

Bad debt expense for the three months ended September 30, 2017 increased by approximately $2.3 million when compared to the same period in 2016. Bad debt as a percentage of revenue was 7.9%, which was higher than last year's rate of 4.5%. Bad debt expense for the nine months ended September 30, 2017 increased by approximately $4.8 million when compared to the same period in 2016. Bad debt as a percentage of revenue was 6.8%, which was higher than last year's rate of 4.5%. The increases in bad debt for both periods are primarily related to changes in payer dynamics including pre authorization denials as well as increased denials for next generation sequencing tests and disease specific multi-gene panels. In addition, there was an impact from the integration of Clarient into our billing system, which began in July of 2016. Clarient had higher bad debt rates than did NeoGenomics' legacy business. Billings of the legacy Clarient billing system have now been either fully collected or written off. The performance of our billing team was also impacted by the integration which ultimately contributed to certain receivables not being collected and increased bad debt expense.

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Professional fees increased by approximately $616,000 for the three months ended September 30, 2017 and $1.4 million for the nine months ended September 30, 2017 when compared to the same periods in 2016, primarily due to fees in 2017 related to the Pharma Services facility in Geneva, Switzerland opening in November of 2017 and an increase in legal reserves for the three months ended September 30, 2017 related to a lawsuit brought against Clarient.

Payroll expenses increased for the three and nine months ended September 30, 2017 when compared to the same periods in 2016. This increase is partially due to additional staff hired for certain functions such as billing, IT and accounts payable that were performed by outside vendors or by General Electric in early 2016 under the Clarient "Transition Services Agreement". We have also seen an increase in stock based compensation which has increased from $3.5 million for the nine months ended September 30, 2016, to $5.0 million for the nine months ended September 30, 2017. This increase is due to the increase in NeoGenomics stock price as well as increase in stock option grants and restricted stock awards.

We expect our general and administrative expenses to increase as we add personnel and equity-related compensation expenses, increase our billing and collections activities; incur additional expenses associated with the expansion of our facilities and backup systems; incur additional bad debt expense as sales increase and as we continue to expand our physical infrastructure to support our anticipated growth. A significant portion of our stock based compensation is for non-employee options which are subject to variable accounting, and our expenses will fluctuate based on the performance of our common stock. A rise in the price of our stock will increase our stock compensation expense, and a decline in our stock price will reduce this expense. However, we anticipate that general and administrative expenses as a percentage of consolidated revenue will drop over the coming years as we continue to grow.

Research and Development Expenses

Research and development expenses relate to cost of developing new proprietary and non-proprietary genetic tests, including payroll and payroll related costs, maintenance and depreciation of laboratory equipment, laboratory supplies (reagents), and outside consultants and experts assisting our research and development team.

Consolidated research and development expenses for the periods presented are as follows:

	Three Months Ended September 30,			Nine Months Ended September 30,		
($ in thousands)	2017	2016	$ Change	2017	2016	$ Change
Research and development	$1,270	$967	$ 303	$3,080	$3,719	$ (639)
As a % of revenue	2.0 %	1.6 %		1.6 %	2.0 %	

Research and development expense increased for the three months ended September 30, 2017 as compared to the same period in 2016. This increase is attributable to non-employee stock options which are subject to variable accounting and the increase in our stock price during the third quarter of 2017. Excluding stock based compensation expense of approximately $531,000 and $187,000 for the three months ended September 30, 2017 and 2016, research

and development expense was approximately $739,000 and $780,000. This decrease is largely due to a decrease in amortization expense for the Health Discovery Corporation license agreements which were being amortized as intangible assets, but were fully impaired in the fourth quarter of 2016.

Research and development expense decreased for the nine months ended September 30, 2017 as compared to the same period in 2016. This decrease is partially attributable to the reduction in the balance of unvested options outstanding in 2017 as compared to 2016 in addition to the decrease in amortization expense for the Health Discovery Corporation license agreements. Excluding stock based compensation expense of approximately $858,000 and $550,000 for the nine months ended September 30, 2017 and 2016, research and development expense was approximately $2.2 million and $3.2 million. The increase in stock based compensation recorded in G&A expense is attributable to non-employee stock options which are subject to variable accounting and the increase in our stock price during the third quarter of 2017.

We expect our research and development expenses to fluctuate in future quarters because of increases or decreases in our stock price and the corresponding stock based compensation expense for non-employee stock options. Increases in our stock price result in additional expense and decreases in our stock price can result in recovery of previously recorded expense. We anticipate research and development expenditures will increase over time as we continue to invest in innovation projects and bringing new tests to market.

Sales and Marketing Expenses

Sales and marketing expenses are primarily attributable to employee-related costs including sales management, sales representatives, sales and marketing consultants and marketing and customer service personnel.

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Consolidated sales and marketing expenses for the periods presented are as follows:

	Three Months Ended September 30,			Nine Months Ended September 30,		
($ in thousands)	2017	2016	$ Change	2017	2016	$ Change
Sales and marketing	$6,577	$5,958	$ 619	$18,466	$18,084	$ 382
As a % of revenue	10.4 %	9.8 %		9.7 %	9.9 %	

Sales and marketing expenses increased for both the three and nine months ended September 30, 2017 as compared to the same period in 2016. This increase is primarily attributable to higher commissions due to our increase in revenues. We expect higher commissions expense in the coming quarters as the sales representatives' focus on generating new business and increasing revenue. In addition, we have increased our investment in marketing related activities in 2017 including trade shows and on-line marketing. We expect our sales and marketing expenses over the long term to increase as our test volumes increase, but to remain stable as a percentage of our overall sales.

Interest Expense, net

Interest expense, net is comprised of interest incurred on our term debt, revolving credit facility and our capital lease obligations offset by the interest income we earn on cash deposits. Interest expense, net decreased in both the three and nine month periods ending September 30, 2017 compared to the same periods in 2016. The decreases in interest expense, net of $70,000 for the three month period and $336,000 for the nine month period reflect the significantly lower borrowing rate in the Loan Agreement entered into in December of 2016. Due to these lower interest rates, while total borrowings have been higher in 2017 compared to 2016, interest expense has been lower. In addition, we have entered into a swap agreement to hedge a significant portion of the interest on our term loan, however part of that loan is not hedged and will continue to fluctuate as the LIBOR rates change.

Net Income

The following table provides consolidated net loss available to common stockholders for each period along with the computation of basic and diluted net loss per share for the three and nine months ended September 30, 2017:

	Three Months Ended		Nine Months Ended	
	September 30 ,		September 30 ,	
(in thousands, except per share amounts)	2017	2016	2017	2016
Net loss available to common shareholders	$(7,751)	$(5,634)	$(13,653)	$(16,200)
Basic weighted average shares outstanding	79,617	78,145	79,208	77,224

Effect of potentially dilutive securities	—	—	—	—
Diluted weighted average shares outstanding	79,617	78,145	79,208	77,224
Basic net loss per share	$(0.10)	$(0.07)	$(0.17)	$(0.21)
Diluted net loss per share	$(0.10)	$(0.07)	$(0.17)	$(0.21)

Non-GAAP Measures

Use of non-GAAP Financial Measures

The Company’s financial results are provided in accordance with accounting principles generally accepted in the United States of America (GAAP) and using certain non-GAAP financial measures. Management believes that presentation of operating results using non-GAAP financial measures provides useful supplemental information to investors and facilitates the analysis of the Company’s operating results and comparison of operating results across reporting periods and between entities. Management also uses non-GAAP financial measures for financial and operational decision making, planning and forecasting purposes and to manage the Company’s business. Management believes that Adjusted EBITDA is a key metric for our business because it is used by our lenders in the calculation of our debt covenants. Management also believes that these non-GAAP financial measures enable investors to evaluate our operating results and future prospects in the same manner as management. The non-GAAP financial measures do not replace the presentation of GAAP financial results and should only be used as a supplement to, and not as a substitute for, the Company’s financial results presented in accordance with GAAP. There are limitations inherent in non-GAAP financial measures because they exclude charges and credits that are required to be included in a GAAP presentation, and do not therefore present the full measure of the Company’s recorded costs against its net revenue. In addition, the Company’s definition of the non-GAAP financial measures below may differ from non-GAAP measures used by other companies.

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Definitions of non-GAAP measures

Non – GAAP EBITDA

We define "EBITDA" as net income from continuing operations before: (i) interest expense, (ii) tax expense, (iii) depreciation and amortization expense.

Non – GAAP Adjusted EBITDA

We define "Adjusted EBITDA" as net income from continuing operations before: (i) interest expense, (ii) tax expense, (iii) depreciation and amortization expense, (iv) non-cash, stock-based compensation expense, and if applicable in a reporting period (v) acquisition-related transaction expenses and other significant non-recurring or non-operating (income) or expenses.

Basis for Non-GAAP Adjustments

Our basis for excluding certain expenses from GAAP financial measures, are outlined below:

- Interest expense – The capital structure of companies significantly affects the amount of interest expense incurred. This expense can vary significantly between periods and between companies. In order to compare performance between periods and companies that have different capital structures and thus different levels of interest obligations, NeoGenomics excludes this expense.
- Income tax expense (benefit) – The tax positions of companies can vary because of their differing abilities to take advantage of tax benefits and because of the tax policies of the jurisdictions in which they operate. As a result, effective tax rates and the provision for income taxes can vary considerably among companies. In order to compare performance between companies, NeoGenomics excludes this expense (benefit).
- Depreciation expense – Companies utilize assets with different useful lives and use different methods of both acquiring and depreciating these assets. These differences can result in considerable variability in the costs of productive assets and the depreciation and amortization expense among companies. In order to compare performance between companies, NeoGenomics excludes this expense.

- Amortization expense – The intangible assets that give rise to this amortization expense relate to acquisitions, and the amounts allocated to such intangible assets and the terms of amortization vary by acquisition and type of asset. NeoGenomics excludes these items to provide a consistent basis for comparing operating results across reporting periods, pre and post-acquisition.
- Stock-based compensation expenses – Although stock-based compensation is an important aspect of the compensation paid to NeoGenomics employees and consultants, the related expense is substantially driven by changes in the Company's stock price in any given quarter, which can fluctuate significantly from quarter to quarter and result in large positive or negative impacts to total operating expenses. The variable accounting treatment causing expense to be driven by changes in quarterly stock price is required because many of the Company's full-time physicians reside in California and are classified as consultants rather than employees due to state regulations. GAAP provides that variable stock based compensation treatment be applied for consultants but not for employees. Without adjusting for these non-cash expenses, the Company believes it would be difficult to compare financial results from operations across reporting periods on a consistent basis.
- Loss on sale of business - The impact of disposals of assets or businesses have been excluded as these losses represent infrequent transactions that impact the comparability between operating periods. We believe the adjustment of these losses supplements the GAAP information by providing a measure that may be used to assess the sustainability of our operating performance.
- Moving expenses – These expenses include costs associated with the move of our Irvine, California facility into our Aliso Viejo facility. Irvine was the former NeoGenomics laboratory in Southern California and was eight miles from Clarient's much larger facility in Aliso Viejo. After investing in updating and redesigning the Aliso Viejo facility, we combined the

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two facilities in March of 2017. Equipment had to be moved and re-validated in the new location. There was also significant overtime and investment of resources to coordinate the move project. Our Irvine, California lease terminated on April 30, 2017 and we also incurred costs in cleaning out and restoring that facility to its original state. We are adjusting for these costs in Adjusted EBITDA as the move was the direct result of the Clarient acquisition and will not be an annually recurring item. Without adjusting for these expenses, the Company believes it would be difficult to compare financial results from operations across reporting periods on a consistent basis.

We believe that EBITDA and Adjusted EBITDA provide more consistent measures of operating performance between entities and across reporting periods by excluding cash and non-cash items of expense that can vary significantly between companies. In addition, adjusted EBITDA is a metric that is used by our lenders in the calculation of our debt covenants. Adjusted EBITDA also assists investors in performing analyses that are consistent with financial models developed by independent research analysts.

EBITDA and Adjusted EBITDA (as defined by us) are not measurements under GAAP and may differ from non-GAAP measures used by other companies. We believe there are limitations inherent in non-GAAP financial measures such as EBITDA and Adjusted EBITDA because they exclude a variety of charges and credits that are required to be included in a GAAP presentation, and do not therefore present the full measure of NeoGenomics recorded costs against its net revenue. Accordingly, we encourage investors to consider both non-GAAP results together with GAAP results in analyzing our financial performance.

The following is a reconciliation of GAAP net income (loss) to Non-GAAP EBITDA and Adjusted EBITDA for the three and nine months ended September 30, 2017:

	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
(in thousands)	2017	2016	2017	2016
Net income (loss) (GAAP)	$(5,100)	$(67)	$(5,797)	$500
Adjustments to net income (loss):				
Interest expense, net	1,398	1,468	4,173	4,509
Income tax expense (benefit)	340	(6)	(539)	500
Amortization of intangibles	1,751	1,818	5,201	5,454
Depreciation	3,833	4,222	11,739	11,550
EBITDA	2,222	7,435	14,777	22,513
Further Adjustments to EBITDA:				
Non-cash stock based compensation	2,760	1,686	5,812	4,024
Loss on sale of business	1,058	-	1,058	-
Facility moving expenses	5	-	620	-
Adjusted EBITDA (non-GAAP), as originally reported	6,045	9,121	22,267	26,537
Impact of accounting error	2,430	-	551	-

Adjusted EBITDA (non-GAAP), as corrected	$8,475	$9,121	$22,818	$26,537

As discussed above and in Item 4, revenue recognized from the fourth quarter of 2016 through the second quarter of 2017 was impacted due to an error relating to revenue accrued for unbilled tests. We assessed the extent of this error and it was corrected in the third quarter of 2017, resulting in a reduction of revenue, and thus a corresponding reduction in Adjusted EBITDA of $2.4 million and $0.6 million for the three and nine months ended September 30, 2017, respectively. See Item 4. Controls and Procedures for additional details regarding this error.

Trade Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are reported net of an allowance for doubtful accounts, which is estimated based on the aging of accounts receivable with each payer category and the historical data on bad debts in these aging categories. In addition, the allowance is adjusted periodically for other relevant factors, including regularly assessing the state of our billing operations in order to identify issues which may impact the collectability of receivables or allowance estimates. Revisions to the allowance are recorded as an adjustment to bad debt expense within general and administrative expenses. After appropriate collection efforts have been exhausted, specific receivables deemed to be uncollectible are charged against the allowance in the period they are deemed uncollectible. Recoveries of receivables previously written-off are recorded as credits to the allowance.

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The following tables present the Company's gross outstanding accounts receivable ($ in thousands) by payer group at September 30, 2017 and December 31, 2016:

AGING OF RECEIVABLES BY PAYER GROUP

September 30, 2017

Payer Group	0-30	%	31-60	%	61-90	%	91-120	%	>120	%	Total	%
Client AR - Pharma	$5,708	8%	$1,367	2%	$217	0%	$249	0%	$373	1%	$7,914	11%
Client AR - Clinical	12,850	17%	8,797	12%	3,146	4%	2,268	3%	4,105	6%	31,166	42%
Total Client AR	18,558		10,164		3,363		2,517		4,478		39,080	
Commercial Insurance	1,045	1%	1,815	3%	1,410	2%	1,493	2%	10,359	14%	16,122	22%
Medicaid	113	0%	289	1%	212	0%	278	0%	961	1%	1,853	2%
Medicare	898	1%	1,354	2%	900	1%	971	1%	5,615	8%	9,738	13%
Private Pay	-	0%	-	0%	-	0%	-	0%	-	0%	-	0%
Unbilled Revenue	6,110	9%	248	0%	34	0%	28	0%	447	1%	6,867	9%
Total	$26,724	36%	$13,870	20%	$5,919	7%	$5,287	6%	$21,860	31%	$73,660	100%

AGING OF RECEIVABLES BY PAYER GROUP

December 31, 2016

Payer Group	0-30	%	31-60	%	61-90	%	91-120	%	>120	%	Total	%
Client AR - Pharma	$2,752	4%	$629	1%	$305	0%	$1,191	2%	$421	1%	$5,298	8%
Client AR - Clinical	10,023	15%	5,891	8%	3,226	5%	1,678	2%	4,808	7%	25,626	37%
Total Client AR	$12,775		$6,520		$3,531		$2,869		$5,229		$30,924	
Commercial Insurance	913	1%	1,947	3%	2,045	3%	1,824	3%	11,325	16%	18,054	26%
Medicaid	88	0%	203	0%	198	0%	180	0%	301	1%	970	1%
Medicare	840	1%	1,300	2%	779	1%	601	1%	3,167	5%	6,687	10%
Private Pay	16	0%	7	0%	10	0%	10	0%	(4)	0%	39	0%
	10,066	15%	1,250	2%	654	1%	225	0%	342	0%	12,537	18%

Unbilled Revenue												
Total	$24,698	36%	$11,227	16%	$7,217	10%	$5,709	8%	$20,360	30%	$69,211	100%

The following table represents the balance in allowance for doubtful accounts (in thousands) and that allowance as a percentage of gross accounts receivable at September 30, 2017 and December 31, 2016:

	September 30, 2017	December 31, 2016	$ Change
Allowance for doubtful accounts	$ 10,937	$ 13,699	$(2,762)
Allowance as a % of gross accounts receivable	14.8 %	19.8 %	
Days Sales Outstanding	91	84	

The allowance for doubtful accounts as well as the allowance as a percentage of gross accounts receivable has decreased for the period ended September 30, 2017 as compared to the period ended December 31, 2016. In December of 2016, due to the Clarient acquisition and integrated related activities; NeoGenomics did not perform a year-end write off of uncollectible receivables as had been done in previous years which resulted in a higher balance in accounts receivable and the allowance as of December 2016. The decreases are also due to changes in the timing of when items are written off and decisions to accelerate certain write-offs in 2017. In 2017, our mix of client billed accounts receivable has increased substantially which tends to lower our allowance as a percentage of gross receivables since client billed accounts receivable have historically had a lower percentage of bad debt than commercial insurance.

Days Sales Outstanding (“DSO”) has increased from 84 days at December 31, 2016 to 91 days as of September 30, 2017. The increase in DSO was partially attributable to an increase in client billed accounts receivable during the third quarter of 2017. Additionally Pharma Services DSO’s were 93 days on December 31, 2016 compared to 104 days on September 30, 2017.

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Liquidity and Capital Resources

To date, we have financed our operations primarily through cash generated thorough operations, public and private sales of equity securities, borrowings against our accounts receivables balances and private debt.

The following table presents a summary of our consolidated cash flows for operating, investing and financing activities for the nine months ended September 30, 2017 and 2016 as well as the period ended cash and cash equivalents and working capital (in thousands).

	Nine Months Ended September 30,	
	2017	2016
Net cash provided by (used in):		
Operating activities	$12,278	$21,718
Investing activities	(10,167)	(5,328)
Financing activities	(2,425)	(10,875)
Net change in cash and cash equivalents	(314)	5,515
Cash and cash equivalents, beginning of period	$12,525	$23,420
Cash and cash equivalents, end of period	$12,211	$28,935
Working Capital [(1)], end of period	$45,633	$57,167

(1) Defined as current assets less current liabilities.

Cash Flows from Operating Activities

During the nine months ended September 30, 2017, cash flows from operating activities was $12.3 million, a $9.4 million decrease compared to the same period in 2016. The decrease was primarily due to an $11.5 million increase in our accounts receivable partially offset by increases in accrued expenses. Our receivables have increased over this period due to growth as well as our higher DSO. We have experienced reimbursement delays due to changes in payer dynamics for Medicare and insurance companies, specifically the increase in these payers requiring pre-authorization and the additional time it may take to get the required authorizations. We have enhanced procedures in our labs to identify requisitions that require pre-authorizations and also educate our clients in order to secure pre-authorizations before the samples arrive in our lab.

Cash Flows from Investing Activities

During the nine months ended September 30, 2017, cash used in investing activities increased by approximately $4.8 million compared to the same period in 2016. This increase was due to equipment purchases and building improvements, which were necessary to support our continued growth and efficiency. Specifically, we have remodeled and upgraded our laboratory facilities in Aliso Viejo, California, expanded our Houston, Texas facility, invested in additional laboratory equipment to accommodate our growth and update existing equipment that was

acquired with the purchase of Clarient. Our Geneva laboratory was substantially finished at the end of the third quarter of 2017 and we have made significant investments in this laboratory facility. We have also invested in a new trade show booth as well as upgrades to our IT security environment and our next generation Laboratory Information System (LIS).

Cash Flows from Financing Activities

During the nine months ended September 30, 2017, cash flows from financing activities decreased by approximately $8.5 million compared to the same period in 2016, primarily due to a $10.0 million repayment on our 2016 revolving credit facility in the first quarter of 2016. The decrease also reflects $5.0 million in advances on our revolving credit facility during the first quarter of 2017, partially offset by a $2.5 million repayment on our revolving credit facility during the third quarter of 2017. The 2016 revolving credit facility was originally used to finance the acquisition of Clarient.

Cash flows from financing activities also include cash received for the issuance of our common stock upon exercise of stock options as well as cash received to purchase shares of our common stock through the Employee Stock Purchase Plan. These sources of cash were offset in 2017 as we made three quarterly repayments of $0.9 million each on our Term Loan as well as payments for various capital lease obligations in both 2016 and 2017. We will continue to have quarterly term loan repayments of $0.9 million in the fourth quarter of 2017 and throughout 2018.

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Credit Facility

During December of 2016, we entered into a new senior secured credit facility in order to reduce our exposure to interest rate fluctuations on this floating rate debt obligation, we also entered into an interest rate swap agreement. For more information on this hedging instrument, see Note E to Consolidated Financial Statements herein. The interest rate swap agreement effectively converts a portion of our floating rate debt to a fixed obligation, thus reducing the impact of interest rate changes on future interest expense. We believe this strategy will enhance our ability to manage cash flow within our Company.

Liquidity Outlook

We had approximately $12.2 million in cash and cash equivalents as of September 30, 2017. In addition, we have a revolving credit facility which provides for up to $75 million in borrowing capacity of which at September 30, 2017, based on our level of adjusted EBITDA, approximately $9.3 million was available. We believe that the cash on hand, available credit lines and positive cash flows generated from operations will provide adequate resources to meet our operating commitments and interest payments for at least the next 12 months from the issuance of these financial statements.

Our Series A Preferred Stock has certain restrictions that will result in the Company having to dedicate fifty percent of the net proceeds from any future equity raise, to redeeming shares of the Series A Preferred Stock until such time as all of the shares of Series A Preferred Stock have been redeemed. In addition, our Credit Agreement contains certain provisions beginning with the Annual Compliance Certificate for the fiscal year ended December 31, 2017 (to be filed no later than March 31, 2018), that would require a portion of the excess cash flow (as defined) to be repaid to our lenders. The debt repayment would be required five business days after the filing of our Annual Compliance Certificate.

Capital Expenditures

We currently forecast capital expenditures in order to execute on our business plan and keep up with the growth in our testing volumes, although the actual amount and timing of such capital expenditures will ultimately be determined by the volume of our business. We currently anticipate that our capital expenditures for the year ended December 31, 2017 will be in the range of $16.0 million to $18.5 million. During the nine months ended September 30, 2017, we purchased approximately $10.2 million of capital equipment, software and leasehold improvements and an additional $3.2 million was acquired through capital lease obligations. We have in the past funded and plan to continue funding these capital expenditures with capital lease financing arrangements, cash, and through bank loan facilities if necessary.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

While many operational aspects of our business are subject to complex federal, state and local regulations, the accounting for our business is generally straightforward with net revenues primarily recognized upon completion of the testing process. Our revenues are primarily comprised of laboratory tests, and approximately one-half of total operating costs and expenses consist of employee compensation and benefits. Due to the nature of our business, several of our accounting policies involve significant estimates and judgments. These accounting policies have been described in our Annual Report on Form 10-K for the year ended December 31, 2016.

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Related Party Transactions

Consulting Agreements

During each of the three and nine month periods ended September 30, 2017 and 2016, Steven C. Jones was an officer, director and shareholder of the Company. In connection with his duties as Executive Vice President, Mr. Jones earned approximately $46,000 and $66,000 for the three months ended September 30, 2017 and 2016, respectively. In addition, as compensation for his services on the Board, Mr. Jones earned approximately $13,000 and $0 for the three months ended September 30, 2017 and 2016, respectively. During the nine months ended September 30, 2017 and 2016, Mr. Jones earned approximately $164,000 and $197,000, respectively in connection with his duties as Executive Vice President. Mr. Jones also received approximately $85,000 and $79,000 during the nine months ended September 30, 2017 and 2016, respectively, as payment of his annual bonus compensation for the previous fiscal years. In addition, as compensation for his services on the Board, Mr. Jones earned $25,000 and $0 for the nine months ended September 30, 2017 and 2016, respectively.

During each of the three and nine month periods ending September 30, 2017 and 2016, Kevin Johnson was a director and shareholder of the Company. In May of 2017, the Company engaged Mr. Johnson to provide services as a consultant, this engagement ended in June of 2017. In connection with his role as a consultant, Mr. Johnson earned approximately $0 and $0 for the three months ended September 30, 2017 and 2016, respectively. In addition, as compensation for his services on the Board, Mr. Johnson earned approximately $14,000 and $15,000, for the three months ended September 30, 2017 and 2016, respectively and approximately $44,000 and $45,000 for the nine months ended September 30, 2017 and 2016, respectively.

On May 25, 2017, the Company granted stock options and restricted stock to each of its board members as part of its annual board compensation process. Mr. Jones and Mr. Johnson were each granted 10,000 stock options and 8,667 shares of restricted stock for their Board services. The options were granted at a price of $7.27 per share and had a weighted average fair market value of $2.38 per option. The options vest ratably over the next three years. The restricted stock has a weighted average fair value of $7.27 per share and vests ratably on the last day of each calendar quarter up to March 31, 2018.

Off-balance Sheet Arrangements

We do not use special purpose entities or other off-balance sheet financing techniques that we believe have, or are reasonably likely to have, a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity or capital resources.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the potential loss arising from adverse changes in market rates and prices, such as foreign currency exchange rates, interest rates and other relevant market rate or price changes. We are exposed to market risk associated with changes in the LIBOR interest rate and foreign currency exchange rates. We regularly evaluate our exposure to such changes and may elect to minimize this risk through the use of interest rate swap agreements. For further details regarding our significant accounting policies relating to derivative instruments and hedging activities, see Note B to our Consolidated Financial Statements included in our Annual Report on Form 10-K. We do not have any material foreign operations or foreign sales and thus have limited exposure to foreign currency exchange rate risk.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the SEC rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

As required by SEC Rule 15d-15, our management carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, we concluded that disclosure controls and procedures were not effective at a reasonable assurance level as a result of a control deficiency that has been identified as a material weakness in our internal control over financial reporting. This material weakness in our internal control over financial reporting and our remediation activities are described below.

Material Weakness in Internal Control over Financial Reporting

During an internal analysis conducted in the third quarter of 2017, we identified an error in the revenue reported in our Form 10-K for the year ended December 31, 2016, Form 10-Q for the quarter ended March 31, 2017 and Form 10-Q for the quarter ended June 30, 2017. Specifically, we determined that certain unbillable tests were inadvertently included in the revenue accrual recorded for the periods beginning in the fourth quarter of 2016 through the second quarter of 2017. These unbillable tests were worked through our laboratory, however we were unable to produce a final result on the sample. The tests were reported back to the ordering physician as Quantity Not Sufficient (“QNS”) or Test Not Performed (“TNP”). Although we incur costs attempting to test these QNS and TNP samples, and often

attempt to get a result more than once, we cannot bill payors for any tests in which a full result is not reported. As a result of the inclusion of these unbillable tests in the monthly revenue accrual, revenue was overstated. This error was corrected in the third quarter of 2017.

We have a policy of writing off any unbilled tests greater than six months old and many of these tests were written off via this process. We assessed the extent of the error on each reported period. As a result of the error, the net impact to revenue reported in the 10-K for the year ended December 31, 2016 has been determined to be immaterial. The net impact of the error in the first quarter of 2017, resulted in an overstatement of revenue by approximately $1.7 million. The net impact of the error in the second quarter of 2017, resulted in an overstatement of revenue by approximately $0.2 million. As a result of the cumulative misstatement through the second quarter of 2017, we recorded a correcting entry in the amount of $1.3 million at the end of the third quarter of 2017. This correction, in addition to approximately $1.1 million in revenues that were reversed earlier in the quarter through the automatic six month write off process, resulted in a reduction of revenue by $2.4 million for the third quarter of 2017.

The management review control that should have detected this error was determined to be ineffective. Management has concluded that this deficiency constitutes a material weakness in our internal control over financial reporting. Nonetheless, we have concluded that this material weakness does not require a restatement or change in our consolidated financial statements for any prior annual or interim period. We have taken certain remediation steps to address the material weakness referenced above, and to improve our internal control over financial reporting as described below.

- We have filled the open position of Vice President and Principal Accounting Officer and we are providing additional resources to our finance team by actively recruiting for a Corporate Controller.

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- We are re-designing and implementing effective review and approval controls over the accurate recording, presentation, and disclosure of revenue
- We have reviewed, identified and corrected errors in the recognition of revenue
- We have established steps in our monthly closing process to improve our internal control over financial reporting. These steps include:

a. monthly review of revenue reports by the Director of Billing to ensure that all unbilled tests outstanding for 60 days or greater are appropriate for accrual and will ultimately be billed out
b. monthly review of revenue reports by the Assistant Controller to ensure that revenue is not being accrued for tests that based on laboratory results are determined to be unbillable

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the three months ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

However, as noted above, we will be implementing changes to our internal control over financial reporting to address the material weakness described above.

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PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time the Company is engaged in legal proceedings in the ordinary course of business. We do not believe any current legal proceedings are material to our business. No material proceedings were terminated during the quarter ended September 30, 2017.

ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those set forth in Part I, Item 1A, “Risk Factors” contained in our Annual Report on Form 10-K for the for the year ended December 31, 2017; as filed with the SEC on March 14, 2017.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

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ITEM 6. EXHIBITS

EXHIBIT

NO.	DESCRIPTION
31.1	Certification by Principal Executive Officer pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by Principal Financial Officer pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Cash Flows and (iv) related notes

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 13, 2017 NEOGENOMICS, INC.

By: /s/ Douglas M. VanOort
Name: Douglas M. VanOort
Title: Chief Executive Officer

By: /s/ George Cardoza
Name: George Cardoza
Title: Chief Financial Officer