DEXCOM INC
Form 10-Q
August 01, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number 000-51222
DEXCOM, INC.
(Exact name of Registrant as specified in its charter)

Delaware	33-0857544
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
6340 Sequence Drive San Diego, California	92121
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, including area code: (858) 200-0200
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer	ý	Accelerated Filer	o
Non-Accelerated Filer	o (Do not check if a smaller reporting company)	Smaller Reporting Company	o
Emerging Growth Company	o		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
As of July 27, 2017, 86,560,946 shares of the Registrant's common stock were outstanding.

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

DexCom, Inc.
Consolidated Balance Sheets
(In millions—except par value data)

	June 30, 2017 (Unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 395.9	$ 94.5
Short-term marketable securities, available-for-sale	100.7	29.2
Accounts receivable, net	101.7	101.7
Inventory	42.8	45.4
Prepaid and other current assets	15.7	9.2
Total current assets	656.8	280.0
Property and equipment, net	125.0	109.4
Goodwill	11.9	11.3
Other assets	1.9	2.1
Total assets	$ 795.6	$ 402.8
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 72.2	$ 68.1
Accrued payroll and related expenses	31.4	33.4
Current portion of deferred revenue	1.5	0.9
Total current liabilities	105.1	102.4
Other liabilities	16.3	16.6
Long term senior convertible notes	320.5	—
Total liabilities	441.9	119.0
Commitments and contingencies (Note 5)		
Stockholders’ equity:		
Preferred stock, $0.001 par value, 5.0 shares authorized; no shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	—	—
Common stock, $0.001 par value, 200.0 authorized; 86.8 and 86.5 issued and outstanding, respectively, at June 30, 2017. Common stock, $0.001 par value, 100.0 authorized; 84.9 and 84.6 shares issued and outstanding, respectively, at December 31, 2016.	0.1	0.1
Additional paid-in capital	1,015.6	905.7
Accumulated other comprehensive loss	(1.6)	(1.0)
Accumulated deficit	(660.4)	(621.0)
Total stockholders’ equity	353.7	283.8
Total liabilities and stockholders’ equity	$ 795.6	$ 402.8

See accompanying notes

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DexCom, Inc.
Consolidated Statements of Operations
(In millions—except per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenues	$170.6	$137.3	$312.9	$253.5
Cost of sales	53.1	51.8	101.3	92.9
Gross profit	117.5	85.5	211.6	160.6
Operating expenses				
Research and development	45.3	36.3	93.4	68.5
Selling, general and administrative	85.8	69.3	172.2	131.4
Total operating expenses	131.1	105.6	265.6	199.9
Operating loss	(13.6)	(20.1)	(54.0)	(39.3)
Other income	1.8	—	2.2	—
Interest income	0.5	0.1	0.7	0.2
Interest expense	(3.1)	(0.1)	(3.6)	(0.2)
Loss before income taxes	(14.4)	(20.1)	(54.7)	(39.3)
Income tax expense (benefit)	(17.3)	0.1	(15.9)	0.1
Net income (loss)	$2.9	$(20.2)	$(38.8)	$(39.4)
Basic and diluted net income (loss) per share	$0.03	$(0.24)	$(0.45)	$(0.48)
Shares used to compute basic net income (loss) per share	86.4	83.6	85.8	82.8
Shares used to compute dilutive net income (loss) per share	87.4	83.6	85.8	82.8

See accompanying notes

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DexCom, Inc.
Consolidated Statements of Comprehensive Income (Loss)
(In millions)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income (loss)	$2.9	$(20.2)	$(38.8)	$(39.4)
Foreign currency translation loss	(0.3)	(0.4)	(0.6)	(0.4)
Comprehensive income (loss)	$2.6	$(20.6)	$(39.4)	$(39.8)

See accompanying notes

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DexCom, Inc.
Consolidated Statements of Cash Flows
(In millions)
(Unaudited)

	Six Months Ended June 30,	
	2017	2016
Operating activities		
Net loss	$(38.8)	$(39.4)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization	7.6	7.3
Share-based compensation	55.9	52.7
Non-cash interest expense	2.1	—
Deferred tax	(17.1)	—
Other non-cash expenses	6.1	0.1
Changes in operating assets and liabilities:		
Accounts receivable, net	0.5	0.8
Inventory	2.8	(7.2)
Prepaid and other assets	(6.2)	(2.7)
Accounts payable and accrued liabilities	1.8	9.3
Accrued payroll and related expenses	(2.1)	(1.7)
Deferred revenue	0.5	(0.2)
Deferred rent and other liabilities	1.5	0.9
Net cash provided by operating activities	14.6	19.9
Investing activities		
Purchase of available-for-sale marketable securities	(91.4)	(20.9)
Proceeds from the maturity of available-for-sale marketable securities	19.6	21.7
Purchase of property and equipment	(34.9)	(22.0)
Acquisitions, net of cash acquired	—	0.4
Net cash used in investing activities	(106.7)	(20.8)
Financing activities		
Net proceeds from issuance of common stock	5.7	4.8
Proceeds from issuance of convertible debt, net of issuance costs	389.0	—
Proceeds from short-term borrowings	75.0	—
Repayment of short-term borrowings	(75.0)	—
Repayment of long-term debt	—	(2.3)
Net cash provided by financing activities	394.7	2.5
Effect of exchange rate changes on cash and cash equivalents	(1.2)	(0.2)
Increase in cash and cash equivalents	301.4	1.4
Cash and cash equivalents, beginning of period	94.5	86.1
Cash and cash equivalents, end of period	$395.9	$87.5
Supplemental disclosure of non-cash investing and financing transactions:		
Issuance of common stock in connection with acquisition	$—	$7.2
Acquisition-related holdback liability	$—	$1.8
Assets acquired and financing obligation under build-to-suit leasing arrangement	$—	$6.0
Acquisition of property and equipment included in accounts payable and accrued liabilities	$4.9	$3.8

See accompanying notes

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DexCom, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

1. Organization and Summary of Significant Accounting Policies

Organization and Business

DexCom, Inc. is a medical device company focused on the design, development and commercialization of continuous glucose monitoring ("CGM") systems for ambulatory use by people with diabetes and by healthcare providers for the treatment of people with diabetes. Unless the context requires otherwise, the terms "we," "us," "our," the "company," or "DexCom" refer to DexCom, Inc. and its subsidiaries.

Basis of Presentation

We have incurred operating losses since our inception and have an accumulated deficit of $660.4 million at June 30, 2017. As of June 30, 2017, we had available cash, cash equivalents and marketable securities totaling $496.6 million and working capital of $551.7 million. Our ability to transition to, and maintain, profitable operations is dependent upon achieving a level of revenues adequate to support our cost structure. If events or circumstances occur such that we do not meet our operating plan as expected, we may be required to reduce planned increases in compensation expenses and other operating expenses needed to support the growth of our business which could have an adverse impact on our ability to achieve our intended business objectives. We believe our working capital resources will be sufficient to fund our operations through at least June 30, 2018.

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, which include only normal recurring adjustments considered necessary for a fair presentation, have been included. Operating results for the three and six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and related notes thereto for the year ended December 31, 2016 included in the Annual Report on Form 10-K filed by us with the Securities and Exchange Commission on February 28, 2017.

Principles of Consolidation

The consolidated financial statements include the accounts of DexCom, Inc. and our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Segment Reporting

An operating segment is identified as a component of a business that has discrete financial information available, and one for which the chief operating decision maker must decide the level of resource allocation. In addition, the guidance for segment reporting indicates certain quantitative thresholds. None of the operations of our subsidiaries meet the definition of an operating segment and are currently not material, but may become material in the future.

We currently consider our operations to be, and manage our business globally within, one reportable segment, which is consistent with how our President and Chief Executive Officer, who is our chief operating decision maker, reviews our business, makes investment and resource allocation decisions and assesses operating performance.

We sell our products through a direct sales force in the United States, Canada and portions of Europe, and through distribution arrangements in the United States, Canada, Australia, New Zealand, and in portions of Europe, Asia, Latin America, the Middle East and Africa. DexCom, Inc. is domiciled in the United States.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates. Significant estimates include excess or obsolete inventories, valuation of inventory, warranty accruals, convertible debt, employee bonus, clinical trial expenses, allowance for bad debt and refunds and rebates, including pharmacy rebates.

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Share-Based Compensation

Share-based compensation expense is measured at the grant date based on the estimated fair value of the award and is recognized ratably over the requisite service period of the individual grants, which typically equals the vesting period. Shared-based compensation arrangements include Restricted Stock Units (“RSUs”) and purchases of common stock at a discount under our Employee Stock Purchase Plan, or ESPP. We estimate the fair value of RSUs based on the market price of our common stock on the date of grant and the fair value of ESPP purchase rights on the date of grant using the Black-Scholes option pricing model.

As discussed below under "Recent Accounting Guidance", we adopted ASU 2016-09, Compensation - Stock Compensation (Topic 718) (“ASU 2016-09”) in the first quarter of 2017 and elected to account for forfeitures as they occur with the change applied on a modified retrospective basis with a cumulative effect adjustment to accumulated deficit of $0.6 million. Prior to the adoption of this accounting standard we estimated at grant the likelihood that the award will ultimately vest (the “pre-vesting forfeiture rate”), and revised the estimate, if necessary, in future periods if the actual forfeiture rate differed. We used our historical data and company-specific events to estimate pre-vesting forfeitures and recorded stock-based compensation expense only for those awards that were expected to vest.

We recorded $25.3 million and $55.9 million in share-based compensation expense during the three and six months ended June 30, 2017, compared to $27.6 million and $52.7 million during the three and six months ended June 30, 2016. At June 30, 2017, unrecognized estimated compensation costs related to unvested restricted stock units totaled $174.2 million and is expected to be recognized through 2020.

Revenue Recognition

We sell our durable systems and disposable units through a direct sales force in the United States, Canada and portions of Europe, and through distribution arrangements in the United States, Canada, Australia, New Zealand, and in portions of Europe, Asia, Latin America, the Middle East, and Africa. Components are individually priced and can be purchased separately or together. We receive payment directly from customers who use our products, as well as from distributors, organizations and third-party payors. Our durable system includes a reusable transmitter, a receiver, a power cord and a USB cable. Disposable sensors for use with the durable system are sold separately in packages of four. We provide free of charge software and mobile applications for use with our durable systems and disposable sensors. The initial durable system price is generally not dependent upon the subsequent purchase of any amount of disposable sensors.

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Revenue on product sales is generally recognized upon shipment, which is when title and the risk of loss have been transferred to the customer and there are no other post shipment obligations. With respect to customers who directly pay for products, the products are generally paid for at the time of shipment using a customer’s credit card and do not include customer acceptance provisions. We recognize revenue from contracted insurance payors based on the contracted rate. For non-contracted insurance payors, we obtain prior authorization from the payor and recognize revenue based on the estimated collectible amount and historical experience. We also receive a prescription or statement of medical necessity and, for insurance reimbursement customers, an assignment of benefits prior to shipment.

We provide a “30-day money back guarantee” program whereby customers who purchase a durable system and a package of four disposable sensors may return the durable system for any reason within thirty days of purchase and receive a full refund of the purchase price of the durable system. We accrue for estimated returns, refunds and rebates, including pharmacy rebates, by reducing revenues and establishing a liability account at the time of shipment based on historical experience. Returns have historically been immaterial. Allowances for rebates include contracted discounts with commercial payors and are amounts owed after the final dispensing of the product by a distributor or retail pharmacy to a pharmacy benefit plan participant and are based upon contractual agreements with private sector benefit providers. The allowance for rebates is based on contractual discount rates, expected utilization under each contract and our estimate of the amount of inventory in the distribution channel that will become subject to such rebates. Our estimates for expected utilization for rebates are based on historical rebate claims and to a lesser extent third party market research data. Rebates are generally invoiced and paid monthly or quarterly in arrears so that our accrual consists of an estimate of the amount expected to be incurred for the current month's or quarter’s activity, plus an

accrual for unpaid rebates from prior periods, and an accrual for inventory in the distribution channel.

We have entered into distribution agreements with Byram Healthcare and its subsidiaries ("Byram"), RGH Enterprises ("Edgepark") and other distributors that allow the distributors to sell our durable systems and disposable units. The majority of our distributors stock our products, and we refer to these distributors as Stocking Distributors, whereby the Stocking Distributors fulfill orders for our product from their inventory. We also have contracts with certain distributors that do not stock our products, but rather products are shipped directly to the customer by us on behalf of our distributor, and we refer to these distributors as Drop-Ship Distributors. Revenue is recognized based on contracted prices. Terms of distributor orders are

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generally Freight on Board (or Free Carrier ("FCA") shipping point for international orders). Distributors do not have rights of return per their distribution agreement outside of our standard warranty. The distributors typically have a limited time frame to notify us of any missing, damaged, defective or non-conforming products. For any such products, we shall either, at our option, replace the portion of defective or non-conforming product at no additional cost to the distributor or cancel the order and refund any portion of the price paid to us at that time for the sale in question. Shipping charges billed to customers are included in revenue while related costs are included as cost of sales.

Warranty Accrual

Estimated warranty costs associated with a product are recorded at the time of shipment. We estimate future warranty costs by analyzing historical warranty experience for the timing and amount of returned product, and expectations for future warranty activity based on changes and improvements to the product or process that are, or will be in place in the future. These estimates are evaluated on at least a quarterly basis to determine the continued appropriateness of such assumptions.

Foreign Currency

The financial statements of our foreign subsidiaries are translated into U.S. dollars for financial reporting purposes. Assets and liabilities are translated at period-end exchange rates, and revenue and expense transactions are translated at average exchange rates for the period. Translation related adjustments are recognized as part of comprehensive income and are included in accumulated other comprehensive loss in the consolidated balance sheet. Gains and losses resulting from certain intercompany transactions as well as transactions with customers and vendors that are denominated in currencies other than the functional currency of each subsidiary give rise to foreign exchange gains or losses reflected in operations. To date the results of operations of these subsidiaries and related translation adjustments and foreign exchange gains or losses have not been material in our consolidated results.

Comprehensive Income (Loss)

We report all components of comprehensive income (loss), including net income (loss), in the consolidated financial statements in the period in which they are recognized. Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Net income (loss) and comprehensive income (loss), including unrealized gains and losses on marketable securities and foreign currency translation adjustments, are reported, net of their related tax effect, to arrive at comprehensive income (loss).

Inventory

Inventory is valued at the lower of cost or market value on a part-by-part basis that approximates first in, first out. We make adjustments to reduce the cost of inventory to its net realizable value, if required, for estimated excess, obsolete and potential scrapped inventories. Factors influencing these adjustments include inventories on hand and on order compared to estimated future usage and sales for existing and new products, as well as judgments regarding quality control testing data, and assumptions about the likelihood of scrap and obsolescence. Once written down the adjustments are considered permanent and are not reversed until the related inventory is sold or disposed.

Our products require customized products and components that currently are available from a limited number of sources. We purchase certain components and materials from single sources due to quality considerations, costs or constraints resulting from regulatory requirements.

Marketable Securities

We have classified our marketable securities with remaining maturity at purchase of more than three months and remaining maturities of one year or less as short-term available-for-sale marketable securities. Marketable securities with remaining maturities of greater than one year are also classified as short-term available-for-sale marketable securities as such marketable securities represent the investment of cash that is available for current operations. We carry our marketable securities at fair value with unrealized gains and losses, if any, reported as a separate component of stockholders' equity and included in comprehensive loss. Realized gains and losses are calculated using the specific identification method and recorded as interest income or expense. We invest in various types of securities, including debt securities in government-sponsored entities, corporate debt securities, U.S. Treasury securities and commercial paper. We do not generally intend to sell the investments and it is not more likely than not that we will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity.

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Fair Value Measurements

Our financial instruments consist principally of cash and cash equivalents, marketable securities, accounts receivable, accounts payable, accrued expenses, and Senior Convertible Notes.

The fair value hierarchy described by the authoritative guidance for fair value measurements is based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value and include the following:

Level 1—Quoted prices in active markets for identical assets or liabilities.

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

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

We carry our marketable securities at fair value. The carrying amounts of financial instruments, such as cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued liabilities, are carried at cost, which approximate the related fair values due to the short-term maturities of these instruments. For additional detail see Note 7 “Fair Value Measurements.”

Property and Equipment

Property and equipment is stated at cost and depreciated over the estimated useful lives of the assets, generally three years for computer equipment, four to ten years for machinery and equipment, and five years for furniture and fixtures, using the straight-line method. Leasehold improvements are stated at cost and amortized over the shorter of the estimated useful lives of the assets or the remaining lease term.

Goodwill

We test goodwill for impairment on an annual basis. Also, between annual tests we test for impairment if events and circumstances indicate it is more likely than not that the fair value is less than the carrying value. Events that would indicate impairment and trigger an interim impairment assessment include, but are not limited to, current economic and market conditions, including a decline in market capitalization, a significant adverse change in legal factors, business climate or operational performance of the business and an adverse action or assessment by a regulator. The change in goodwill for the three and six months ended June 30, 2017 represents translation adjustments on our foreign currency denominated goodwill related to the acquisition of Nintamed, our distributor that served Germany, Switzerland and Austria.

Recent Accounting Guidance

In May 2014, the Financial Accounting Standards Board ("FASB") issued authoritative guidance for Revenue from Contracts with Customers, to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of the guidance is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. The guidance defines a five step process to achieve this core principle and it is possible when the five step process is applied, more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The updated standard permits the use of either the retrospective or modified retrospective transition method and is effective for us in our first quarter of 2018. We are currently in the process of completing the initial assessment of the impact that this new revenue recognition standard will have on our consolidated financial statements. As part of the initial assessment, we are reviewing a representative sample of contracts across our various streams of revenue and geographies to identify potential differences that could result from applying the requirements of the new standard. The analysis includes identifying whether there may be differences in timing of revenue recognition under the new standard as well as assessing performance obligations, variable consideration and contract costs. We have not yet estimated the impact, if any, of the new standard on the timing and pattern of our revenue recognition. We will continue to evaluate the future impact and method of adoption of ASU 2014 -09 and related amendments on the Consolidated Financial Statements and related disclosures throughout 2017.

In July 2015, the FASB issued guidance to change the subsequent measurement of inventory from lower of cost or market to lower of cost and net realizable value. The guidance requires that inventory accounted for under the first-in, first-out

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(FIFO) or average cost methods be measured at the lower of cost and net realizable value, where net realizable value represents the estimated selling price of inventory in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The guidance was effective for us in the first quarter of fiscal 2017 with no material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"), which require a lessee to recognize a lease payment liability and a corresponding right of use asset on their balance sheet for all lease terms longer than 12 months, lessor accounting remains largely unchanged. ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2018 and early adoption is permitted. We are currently evaluating the effect this guidance will have on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718) ("ASU 2016-09"), which is intended to simplify several areas of accounting for share-based payment arrangements. The amendments in this update cover such areas as the recognition of excess tax benefits and deficiencies, the classification of those excess benefits on the statement of cash flows, an accounting policy election for forfeitures, the amount an employer can withhold to cover income taxes and still qualify for equity classification and the classification of those taxes paid on the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, and interim periods within those annual periods. We adopted this standard in the first quarter of 2017.

We had excess tax benefits for which a benefit could not be previously recognized of approximately $161.0 million. Upon adoption, we recognized the previously unrecognized excess tax benefits of $161.0 million deferred tax assets with an offsetting increase in our valuation allowance using a modified retrospective method through a cumulative effect adjustment to the accumulated deficit, with no net impact on our financial statements. All excess tax benefits and all tax deficiencies generated in the current and future periods will be recognized prospectively and recorded as income tax benefit or expense in our Consolidated Statements of Operations in the reporting period in which they occur. Until such time that we release our valuation allowance against deferred tax assets, the tax impact of any excess tax benefits and deficiencies will be offset with the change in our valuation allowance. In addition, we elected to account for forfeitures as they occur with the change applied on a modified retrospective basis with a cumulative effect adjustment to accumulated deficit of $0.6 million. Due to the full valuation allowance on the U.S. deferred tax assets, we have determined that none of the provisions of ASU 2016-09 will have a significant impact on our 2017 consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, Accounting for Income Taxes - Intra-Entity Asset Transfer other than Inventory (Topic 740) ("ASU 2016-16"), which would require the recognition of the tax expense from the sale of an asset other than inventory when the transfer occurs, rather than when the asset is sold to a third party or otherwise recovered through use. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The amendment should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning period of adoption. We are considering the impact the adoption of ASU 2016-16 may have on our consolidated financial statements.

2. Net Income (Loss) Per Common Share

Basic net income (loss) per share attributable to common stockholders is calculated by dividing the net income (loss) attributable to common stockholders by the weighted-average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted net income (loss) per share is computed using the weighted average number of common shares outstanding and, when dilutive, potential common share equivalents from outstanding options and unvested RSUs settleable in shares of common stock (using the treasury-stock method), and potential common shares from convertible securities (using the if-converted method). Because the Company reported a net loss for the six months ended June 30, 2017 and the three and six months ended June 30, 2016, all potential dilutive common shares have been excluded from the computation of the diluted net income (loss) per share for all periods presented, as the effect would have been anti-dilutive.

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The following table sets forth the computation of basic and diluted net income (loss) per share (in millions, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income (loss)	$2.9	$(20.2)	$(38.8)	$(39.4)
Net income (loss) per common share:				
Basic	$0.03	$(0.24)	$(0.45)	$(0.48)
Diluted	$0.03	$(0.24)	$(0.45)	$(0.48)
Basic weighted average shares outstanding	86.4	83.6	85.8	82.8
Effect of potentially dilutive share-based awards	1.0	—	—	—
Diluted weighted average shares outstanding	87.4	83.6	85.8	82.8

Outstanding anti-dilutive securities not included in diluted net income (loss) per share attributable to common stockholders calculation (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Options outstanding to purchase common stock	—	1.0	0.4	1.0
Unvested restricted stock units	0.1	3.9	3.0	3.9
Senior convertible notes	4.0	—	4.0	—
Total	4.1	4.9	7.4	4.9

3. Financial Statement Details (in millions)

Short-Term Marketable Securities, Available-for-Sale

Short-term marketable securities, consisting solely of debt securities, were as follows:

	June 30, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. government agencies	$70.6	$ —	$ —	$ 70.6
Commercial paper	25.2	—	—	25.2
Corporate debt	4.9	—	—	4.9
Total	$100.7	$ —	$ —	$ 100.7

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. government agencies	$22.2	$ —	$ —	$ 22.2
Corporate debt	3.8	—	—	3.8
Commercial paper	3.2	—	—	3.2
Total	$29.2	$ —	$ —	$ 29.2

As of June 30, 2017, the estimated market value of available-for-sale marketable securities with contractual maturities of up to one year and up to 17 months were $83.5 million and $17.2 million, respectively.

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Inventory

	June 30, 2017	December 31, 2016
Raw materials	$16.3	$ 20.1
Work-in-process	4.1	2.3
Finished goods	22.4	23.0
Total	$42.8	$ 45.4

During 2016, we recorded charges of $3.5 million in cost of goods sold related to excess and obsolete receiver inventory primarily related to the February 23, 2016 customer notification regarding the audible alarms and alerts associated with our receivers which was classified as a voluntary Class 1 recall by the FDA.

Property and Equipment

	June 30, 2017	December 31, 2016
Building [(1)]	$6.0	$ 6.0
Furniture and fixtures	4.7	5.8
Computer equipment	23.6	22.7
Machinery and equipment	32.1	31.4
Leasehold improvements	33.1	25.6
Construction in progress	74.2	65.1
Total	173.7	156.6
Accumulated depreciation and amortization	(48.7)	(47.2)
Property and equipment, net	$125.0	$ 109.4

(1) As described in Footnote 5 “Commitments and Contingencies,” although we do not legally own these premises, we are deemed the owner of the construction project during the construction period of our new manufacturing facility in Mesa, Arizona under a build-to-suit lease arrangement.

Accounts Payable and Accrued Liabilities

	June 30, 2017	December 31, 2016
Accounts payable trade	$16.8	$ 24.5
Accrued tax, audit, and legal fees	13.6	4.5
Clinical trials	0.3	1.1
Accrued rebates	13.0	8.2
Accrued warranty	8.3	9.8
Accrued other	20.2	20.0
Total	$72.2	$ 68.1

Accrued Warranty

Warranty costs are reflected in the consolidated statements of operations as product cost of sales. A reconciliation of our accrued warranty costs for the three and six months ended June 30, 2017 and 2016 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Beginning balance	$9.9	$5.7	$9.8	$3.3
Charges to costs and expenses	3.4	7.3	8.4	13.5
Costs incurred	(5.0)	(5.1)	(9.9)	(8.9)

Ending balance	$8.3	$7.9	$8.3	$7.9

Other Liabilities

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	June 30, 2017	December 31, 2016
Financing lease obligations	$6.7	$ 6.7
Deferred rent	8.9	7.3
Other	0.7	2.6
Total	$16.3	$ 16.6

4. Debt

0.75% Senior Convertible Notes due 2022

	June 30, 2017	December 31, 2016
0.75% Senior convertible notes due 2022:		
Principal amount	$400.0	$ —
Unamortized debt discount	(70.7)	—
Unamortized debt issuance costs	(8.8)	—
Net carrying amount of senior convertible notes	$320.5	$ —
Fair value of outstanding notes	$409.7	$ —

In May 2017, we completed an offering of $350.0 million aggregate principal amount of 0.75% convertible senior notes due 2022 (the "2022 Notes") and, in June 2017 the initial purchasers exercised their option to purchase an additional $50.0 million aggregate principal amount of 2022 Notes. The 2022 Notes have a stated interest rate of 0.75% and a maturity date of May 15, 2022. The net proceeds from the offering, after deducting initial purchasers' discounts and costs directly related to the offering, were approximately $389.0 million. The 2022 Notes may be settled in cash, stock, or a combination thereof, solely at the Company's discretion. The initial conversion rate of the 2022 Notes is 10.0918 shares per $1,000 principal amount, which is equivalent to a conversion price of approximately $99.09 per share, subject to adjustments. The Company uses the if-converted method for assumed conversion of the 2022 Notes to compute the weighted average shares of common stock outstanding for diluted earnings per share.

As upon conversion by the holders, we may elect to settle such conversion in shares of its common stock, cash, or a combination thereof, we accounted for the cash conversion option as an equity instrument classified to stockholders' equity, which resulted in recognizing $72.6 million in additional paid-in-capital during 2017.

The interest expense recognized on the 2022 Notes during the three and six months ended June 30, 2017 includes $0.4 million, $1.8 million and $0.2 million for the contractual coupon interest, the accretion of the debt discount and the amortization of the debt issuance costs, respectively. The effective interest rate on the 2022 Notes is 5.5%, which includes the interest on the notes, amortization of the debt discount and debt issuance costs. The discount on the 2022 Notes is amortized through February 15, 2022. Interest on the 2022 Notes began accruing upon issuance and is payable semi-annually on May 15 and November 15 of each year.

Holders of the Notes who convert their Notes in connection with a make-whole fundamental change (as defined in the Indenture) or following the delivery by DexCom of a notice of redemption are, under certain circumstances, entitled to an increase in the conversion rate.

Additionally, in the event of a fundamental change (as defined in the Indenture), holders of the Notes may require DexCom to repurchase all or a portion of their Notes at a price equal to 100% of the principal amount of Notes, plus any accrued and unpaid interest, including any additional interest, to, but excluding, the repurchase date.

Holders of the Notes may convert all or a portion of their Notes at their option prior to 5:00 p.m., New York City time, on the business day immediately preceding February 15, 2022, in multiples of $1,000 principal amount, only under the following circumstances:

- during any calendar quarter commencing after September 30, 2017 (and only during such calendar quarter), if the last reported sale price of common stock for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than

or equal to 130% of the applicable conversion price of the Notes on each such trading day;

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- during the five business day period after any five consecutive trading day period in which the trading price per $1,000 principal amount of the Notes for each day of that five day consecutive trading day period was less than 98% of the product of the last reported sale price of common stock and the applicable conversion rate of the Notes on such trading day;
- if DexCom calls any or all of the Notes for redemption, at any time prior to the close on business on the scheduled trading day immediately preceding the redemption date; or
- upon the occurrence of specified corporate transactions.

On or after February 15, 2022, until 5:00 p.m., New York City time, on the business day immediately preceding the maturity date, holders of the Notes may convert all or a portion of their Notes regardless of the foregoing circumstances.

The redemption price will be equal to 100% of the principal amount of such 2022 Notes to be redeemed plus accrued and unpaid interest to, but excluding, the redemption date. No principal payments are due on the 2022 Notes prior to maturity. Other than restrictions relating to certain fundamental changes and consolidations, mergers or asset sales and customary anti-dilution adjustments, the Indenture includes customary terms and covenants, including certain events of default after which the Notes may be due and payable immediately. The Company is unaware of any current events or market conditions that would allow holders to convert the 2022 Notes.

Revolving Credit Agreement

In June 2016, we entered into a $200.0 million revolving credit agreement (the “Credit Agreement”), and amended in May 2017, with JPMorgan Chase Bank, NA, as administrative agent, Bank of America, Silicon Valley Bank and Union Bank. In addition to allowing borrowings in US dollars, the Credit Agreement provides a $25.0 million sublimit for borrowings in Canadian Dollars, Euros, British Pounds, Swedish Krona, Japanese Yen and any other currency that is subsequently approved by JPMorgan Chase and each lender. The Credit Agreement also provides a sub-facility of up to $10.0 million for letters of credit, of which $5.6 million is still available. The interest rate under the Credit Agreement ranges from 0.75% to 2.75% plus our choice of one of two base rates, LIBOR or a rate based on the publicly announced JPMorgan Chase prime rate, the federal funds rate or the overnight bank funding rate. We will also pay a commitment fee of between 0.25% and 0.45%, payable quarterly in arrears, on the average daily unused amount of the revolving facility based on our leverage ratio. The aggregate debt issuance costs and fees incurred with respect to entering into the Credit Agreement were $0.7 million, which have been capitalized on our Consolidated Balance Sheet within “Other Assets” and will be amortized through the maturity date of June 2021 on a straight line basis. The obligations of DexCom under the Credit Agreement are guaranteed by DexCom’s existing and future wholly-owned domestic subsidiaries, and are secured by a first-priority security interest in substantially all of the assets of DexCom and the guarantors, including all or a portion of the equity interests of DexCom’s domestic subsidiaries and first-tier foreign subsidiaries but excluding real property and intellectual property (which is subject to a negative pledge).

Short-term borrowings

On March 3, 2017 we drew $75.0 million on the Credit Agreement under a six month term. We repaid the entire principal balance on May 19, 2017. As of June 30, 2017 we had no outstanding borrowings under the Credit Agreement, and $200.0 million under the Credit Agreement remains available.

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5. Commitments and Contingencies

Leases

Under the office lease agreement, as amended (the “Office Lease”), with John Hancock Life Insurance Company (U.S.A.) (the “Landlord”) we lease approximately 219,000 square feet of space in the buildings at 6340 Sequence Drive, 6310 Sequence Drive and 6290 Sequence Drive. The amended Office Lease term extends through March 2022 and we have an option to renew the lease upon the expiration of the initial term for two additional five-year terms by giving notice to the Landlord prior to the end of the initial term of the lease and any extension period, if applicable. Provided we are not in default under the Office Lease and the Office Lease is still in effect, we generally have the right to terminate the lease starting at the 55th month of the Office Lease. We have received $3.6 million of tenant improvement allowance associated with the Office Lease, which is recorded as a deferred rent obligation and amortized over the term of the lease and reflected as a reduction to rent expense. Leasehold improvements associated with the tenant improvement allowance are included in Property and equipment, net in our consolidated balance sheets. On February 1, 2016, we entered into a Sublease (the “Sublease”) with Entropic Communications, LLC with respect to the building at 6350 Sequence Drive in San Diego, California (the “6350 Building”). Under the Sublease, we have leased approximately 132,600 square feet of space in the 6350 Building. The Sublease term extends through January 2022.

On April 28, 2016, we entered into a certain Industrial Net Lease (the “Mesa Lease”) with PRA/LB, L.L.C. with respect to facilities in the building at 232 South Dobson Road in Mesa, Arizona (the “Mesa Building"). Under the Mesa Lease, we have leased approximately 148,797 square feet of space in the Mesa Building, of which approximately 78,000 square feet was available to us on May 1, 2016 and the remaining portion of the Mesa Building will become available to us on or around January 1, 2018. The term of the Mesa Lease extends through March 2028 with four options to extend the Mesa Lease term, each for five-year periods. The Mesa Lease arrangement involves the construction of our new manufacturing facility where we are involved in the design and construction of the leased space, including non-standard tenant improvements paid for by us. This arrangement is referred to as a build-to suit lease and for accounting purposes, we are considered the owner of the construction project during the construction period. During the second quarter of 2016, we capitalized the fair value of the Mesa Building of $6.0 million within “Property and Equipment, net,” and recorded a corresponding financing lease obligation liability of $6.0 million within “Other Liabilities” in the Consolidated Balance Sheet. We have concluded that the Mesa Lease does not qualify for “sale-leaseback” treatment due to prohibited continuing involvement, accordingly the Mesa Lease will be treated as a financing arrangement.

We have also entered into other operating lease agreements, primarily for office and warehouse space, that expire at various times through July 2026. These facility leases have annual rental increases ranging from approximately 2.5% to 4%. The difference between the straight-line expense over the term of the lease and actual amounts paid are recorded as deferred rent.

Rental obligations, excluding real estate taxes, operating costs, and tenant improvement allowances, under all lease agreements as of June 30, 2017 were as follows (in millions):

Fiscal Year Ending	
Remainder of 2017	$4.2
2018	9.9
2019	10.8
2020	11.2
2021	11.5
Thereafter	13.0
Total	$60.6

Total rent expense for the three and six months ended June 30, 2017 was $2.8 million and $5.6 million, compared to $2.3 million and $4.2 million for the same periods in 2016.

Litigation

On March 28, 2016, AgaMatrix, Inc. filed a patent infringement lawsuit against us in the United States District Court for the District of Oregon, asserting that certain of our products infringe certain patents held by AgaMatrix. On June 6, 2016, AgaMatrix filed a First Amended Complaint asserting the same three patents. On August 25, 2016, we filed petitions for inter partes review with the Patent Trial and Appeal Board of the U.S. Patent and Trademark Office seeking a determination that two of the three asserted patents are invalid under the U.S. patent law and those petitions were granted on March 6, 2017. Based on those grants, most activity in the patent infringement lawsuit against us in the District of Oregon was stayed until the inter

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partes review of the Patent Trial and Appeal Board is completed. On March 8, 2017, we filed a petition for inter partes review with the Patent Trial and Appeal Board seeking a determination that the third of the three asserted patents is invalid under U.S. patent law. This petition is still pending. It is our position that AgaMatrix's assertions of infringement have no merit. On August 6, 2016, DexCom filed a patent infringement lawsuit in the United States Central District Court of California, asserting certain AgaMatrix products infringed a patent held by DexCom. On September 30, 2016 DexCom filed a First Amended Complaint asserting the same patent. DexCom believes certain AgaMatrix single-point blood glucose monitoring products infringe the asserted patent. Neither the outcome of the litigation nor the amount and range of potential fees associated with the litigation can be assessed at this time. As of June 30, 2017, no amounts have been accrued in respect of this litigation.

We are subject to various claims, complaints and legal actions that arise from time to time in the normal course of business, including commercial insurance, product liability and employment related matters. In addition from time to time, we may bring claims or initiate lawsuits against various third parties with respect to matters arising out of the ordinary course of our business, including commercial and employment related matters. We do not expect that the resolution of these matters would, or will, have a material adverse effect or material impact on our consolidated financial position.

Purchase Commitments

We are party to various purchase arrangements related to our manufacturing and development activities including materials used in our CGM systems. As of June 30, 2017, we had purchase commitments with vendors totaling $70.7 million due within one year. There are no material purchase commitments due beyond one year.

6. Development and Other Agreements

Collaboration with Verily Life Sciences

On August 10, 2015, we entered into a Collaboration and License Agreement (the "Verily Collaboration Agreement") with Google Life Sciences LLC, now renamed Verily Life Sciences ("Verily"). Pursuant to the Verily Collaboration Agreement, we and Verily have agreed to jointly develop a series of next-generation CGM products. The Verily Collaboration Agreement provides us with an exclusive license to use certain intellectual property of Verily related to the development, manufacture and commercialization of the products contemplated under the Verily Collaboration Agreement. The Verily Collaboration Agreement provides for the establishment of a joint steering committee, joint development committee and joint commercialization committee to oversee and coordinate the parties' activities under the collaboration. We and Verily have agreed to make committee decisions by consensus. Certain aspects of this collaboration were clarified and amended on October 25, 2016.

Under the terms of Verily Collaboration Agreement we paid an upfront fee of $35.0 million through the issuance of 404,591 shares of our common stock. We recorded $36.5 million in research and development expense in our consolidated statement of operations during 2015 related to the issuance of the 404,591 shares of our common stock, based on our stock price of $90.29 per share as of the date of Verily Collaboration Agreement. In addition, we will pay Verily up to $65.0 million in additional milestones upon achievement of various development and regulatory objectives, which payments may be paid in cash or shares of our common stock at our sole election, calculated based on the volume weighted average trading price during a period of twenty consecutive trading days ending on the trading day prior to the date on which the applicable objective has been achieved.

In addition, Verily is eligible to receive tiered royalty payments associated with the commercialization of the products contemplated under the Verily Collaboration Agreement, which are subject to regulatory approval. Unless we attain annual product sales subject to the Verily Collaboration Agreement in excess of $750.0 million, there will be no royalty paid by us to Verily. Above this range, and upon marketing approval of the initial product contemplated by the Verily Collaboration Agreement, or upon commercialization of any other DexCom product that incorporates Verily intellectual property, we will pay to Verily a royalty percentage starting in the high single digits and declining to the mid-single digits based on our annual aggregate product sales.

The Verily Collaboration Agreement shall be terminable by either party (a) upon uncured material breach of the Verily Collaboration Agreement by the other party, (b) if the second product contemplated by the Verily Collaboration Agreement has not been submitted to the FDA for approval by a specified date and (c) if the annual net

sales for the products developed with Verily under the Verily Collaboration Agreement are less than a specified aggregate dollar amount. Additionally, we have the right to terminate the Verily Collaboration Agreement upon the expiration of the last to expire patent that covers a product developed under the Verily Collaboration Agreement.

7. Fair Value Measurements

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We base the fair value of our Level 1 financial instruments that are in active markets using quoted market prices for identical instruments.

We obtain the fair value of our Level 2 financial instruments, which are not in active markets, from a primary professional pricing source using quoted market prices for identical or comparable instruments, rather than direct observations of quoted prices in active markets. Fair value obtained from this professional pricing source can also be based on pricing models whereby all significant observable inputs, including maturity dates, issue dates, settlement date, benchmark yields, reported trades, broker-dealer quotes, issue spreads, benchmark securities, bids, offers or other market related data, are observable or can be derived from, or corroborated by, observable market data for substantially the full term of the asset.

We validate the quoted market prices provided by our primary pricing service by comparing the fair values of our Level 2 marketable securities portfolio balance provided by our primary pricing service against the fair values of our Level 2 marketable securities portfolio balance provided by our investment managers.

The following table represents our fair value hierarchy for our financial assets (cash equivalents and marketable securities) measured at fair value on a recurring basis as of June 30, 2017 (in millions):

	Fair Value Measurements Using Level 1	Level 2	Level 3	Total
Cash equivalents	$—	$349.1	$—	$349.1
Marketable securities, available for sale				
U.S. government agencies	—	70.6	—	70.6
Commercial paper	—	25.2	—	25.2
Corporate debt	—	4.9	—	4.9
Total marketable securities, available for sale	$—	$100.7	$—	$100.7

The following table represents our fair value hierarchy for our financial assets (cash equivalents and marketable securities) measured at fair value on a recurring basis as of December 31, 2016 (in millions):

	Fair Value Measurements Using Level 1	Level 2	Level 3	Total
Cash equivalents	$—	$32.3	$—	$32.3
Marketable securities, available for sale				
U.S. government agencies	—	22.2	—	22.2
Corporate debt	—	3.8	—	3.8
Commercial paper	—	3.2	—	3.2
Total marketable securities, available for sale	$—	$29.2	$—	$29.2

There were no transfers between Level 1 and Level 2 securities during the three and six months ended June 30, 2017 and 2016. There were no transfers into or out of Level 3 securities during the three and six months ended June 30, 2017 and 2016.

The fair value, based on significant unobservable inputs (Level 3), of the Company’s outstanding 2022 Notes was $409.7 million at June 30, 2017. See Note 4 to the Unaudited Consolidated Financial Statements for further discussion on the carrying value of the Company’s 2022 Notes.

8. Income Taxes

Our effective tax rate for the three months ended June 30, 2017 was 120.1% compared to a negative rate of 0.5% for the three months ended June 30, 2016. Our effective tax rate was impacted primarily by a $17.1 million benefit related to the issuance of convertible debt. Under intraperiod allocation, the deferred tax liability related to the equity component of convertible debt is a source of income that can be used to recognize the tax benefit of the current year loss through continuing operations. The estimated tax benefit for the year is recorded at each interim period through the annual effective tax rate and may change with updates to our earnings through the future quarters of 2017. The tax benefit related to the issuance of the convertible debt will not recur in future years. The income tax benefit was offset

by current income tax expense in profitable jurisdictions, withholding taxes, and state taxes.
We maintain a full valuation allowance against our net deferred tax assets as of June 30, 2017 based on our assessment that it is not more likely than not these future benefits will be realized before expiration.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements that are not purely historical regarding DexCom's or its management's intentions, beliefs, expectations and strategies for the future. These forward-looking statements fall within the meaning of the federal securities laws that relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "expect," "plan," "anticipate," "believe," "estimate," "intend," "potential" or "continue" or the negative of these terms or other comparable terminology. Forward-looking statements are made as of the date of this report, deal with future events, are subject to various risks and uncertainties, and actual results could differ materially from those anticipated in those forward looking statements. The risks and uncertainties that could cause actual results to differ materially are more fully described under "Risk Factors" and elsewhere in this report and in our other reports filed with the SEC. We assume no obligation to update any of the forward-looking statements after the date of this report or to conform these forward-looking statements to actual results.

Overview

We are a medical device company primarily focused on the design, development and commercialization of continuous glucose monitoring ("CGM") systems for use by people with diabetes and by healthcare providers for the treatment of people with diabetes. Unless the context requires otherwise, the terms "we," "us," "our," the "company," or "DexCom" refer to DexCom, Inc. and its subsidiaries.

From inception to 2006, we devoted substantially all of our resources to start-up activities, raising capital and research and development, including product design, testing, manufacturing and clinical trials. Since 2006, we have devoted considerable resources to the commercialization of our continuous glucose monitoring systems, including the G4 PLATINUM and G5 Mobile, as well as the continued research and clinical development of our technology platform. From inception through June 30, 2017, we have generated $2.0 billion of product and development grant and other (non-product) revenue, and we have incurred operating losses in each year since our inception in May 1999. As of June 30, 2017, we had an accumulated deficit of $660.4 million. We expect our losses to continue as we proceed with our commercialization and research and development activities. We have financed our operations primarily through offerings of equity securities and debt, and the sales of our products.

Financial Operations

Revenue

We sell our durable systems and disposable units through a direct sales force in the United States, Canada and portions of Europe, and through distribution arrangements in the United States, Canada, Australia, New Zealand, and in portions of Europe, Asia, Latin America, the Middle East and Africa. We have contracts with certain distributors, the majority of whom stock our products, and we refer to these distributors as Stocking Distributors, whereby the Stocking Distributors fulfill orders for our product from their inventory. We also have contracts with certain distributors that do not stock our products, but rather products are shipped directly to the customer by us on behalf of our distributor, and we refer to these distributors as Drop-Ship Distributors. We expect that revenues we generate from the sales of our products will fluctuate from quarter to quarter. We typically experience seasonality with lower sales in the first quarter of each year, compared to the previous fourth quarter, related to annual insurance deductible resets and unfunded flexible spending accounts.

Cost of Sales

Cost of sales includes direct labor and materials costs related to each product sold or produced, including assembly, test labor and scrap, as well as factory overhead supporting our manufacturing operations. Factory overhead includes facilities, material procurement and control, manufacturing engineering, quality assurance, supervision and management. These costs are primarily salary, fringe benefits, share-based compensation, facility expense, supplies and purchased services. A portion of our costs are currently fixed due to our moderate level of production volumes compared to our potential capacity. All of our manufacturing costs are included in cost of sales.

Research and Development

Our research and development expenses primarily consist of engineering and research expenses related to our continuous glucose monitoring technology, clinical trials, regulatory expenses, quality assurance programs, materials and products for clinical trials. Research and development expenses are primarily related to employee compensation, including salary, fringe benefits, share-based compensation, and temporary employee expenses. We also incur significant expenses to operate our clinical trials including clinical site reimbursement, clinical trial product and associated travel expenses. Our research and development expenses also include fees for design services, contractors and development materials.

Selling, General and Administrative

Our selling, general and administrative expenses primarily consist of salary, fringe benefits and share-based compensation for our executive, financial, sales, marketing, information technology and administrative functions. Other significant expenses include commissions, marketing and advertising, IT software license costs, insurance, professional fees for our outside legal counsel and independent auditors, litigation expenses, patent application expenses and consulting expenses.

Results of Operations

Quarter Ended June 30, 2017 Compared to June 30, 2016

Revenue, Cost of Sales and Gross Profit

Revenues increased $33.3 million to $170.6 million for the three months ended June 30, 2017 compared to $137.3 million for the three months ended June 30, 2016 based primarily on increased sales volume of our disposable sensors due to the continued growth of our installed base of customers using our G4 PLATINUM and G5 Mobile systems, and durable systems to both new and existing customers. Revenue attributable to our disposable sensors and durable systems was approximately 70% and 30%, respectively, of revenue, for each of the three months ended June 30, 2017 and June 30, 2016. Revenue from products shipped to our distributors, which are primarily Stocking Distributors, for the three months ended June 30, 2017 was approximately $125.6 million or 74% of our revenue compared to $95.3 million or 69% of our total revenue for the three months ended June 30, 2016.

Cost of sales increased $1.3 million to $53.1 million for the three months ended June 30, 2017 compared to $51.8 million for the three months ended June 30, 2016, primarily due to increased sales volume. The gross profit of $117.5 million, or 69% for the three months ended June 30, 2017 increased $32.0 million compared to $85.5 million, or 62%, for the same period in 2016, primarily due to increased revenue and a decrease in warranty costs.