

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.
Form 10-K
March 06, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2016

Or

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

For the transition period from to

Commission File Number 001-34899

Pacific Biosciences of California, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

16-1590339
(I.R.S. Employer

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incorporation or organization) Identification No.)

1305 O'Brien Drive

Menlo Park, CA 94025 94025
(Address of principal executive offices) (Zip Code)

(Registrant's telephone number, including area code)

(650) 521-8000

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

Title of Each Class	Name of Each Exchange on Which Registered
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Common Stock, par value \$0.001 per share	The NASDAQ Stock Market LLC
-------------------------------------------	-----------------------------

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

None

Indicate by check mark if the registrant is a well-known, seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

Aggregate market value of registrant's common stock held by non-affiliates of the registrant on June 30, 2016, based upon the closing price of Common Stock on such date as reported by NASDAQ Global Select Market, was approximately \$564,220,000. Shares of voting stock held by each officer and director have been excluded in that such persons may be deemed to be affiliates. This assumption regarding affiliate status is not necessarily a conclusive determination for other purposes.

Number of shares outstanding of the issuer's common stock as of February 28, 2017: 92,725,347

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the registrant's definitive Proxy Statement relating to its 2017 Annual Meeting of Stockholders to be held on May 24, 2017 are incorporated by reference into Part III of this Form 10-K where indicated. Such Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

Pacific Biosciences of California, Inc.

Annual Report on Form 10-K

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Discussions under the captions “Business,” “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contain or may contain forward-looking statements that are based on the beliefs and assumptions of the management of Pacific Biosciences of California, Inc. (the “Company,” “we,” “us,” or “our”) and on information currently available to our management. The statements contained in this Annual Report on Form 10-K that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and include, but are not limited to, our statements regarding the attributes and sequencing advantages of SMRT® technology and the Sequel™ System, market opportunities, strategic plans, including strategy for our business and related financing, expectations regarding the conversion of backlog to revenue and the pricing and gross margin for products, expectations regarding our collaboration agreements, manufacturing plans including scaling of manufacturing of Sequel Systems and delivery of products, research and development plans, product development including, among other things, statements relating to future uses, quality or performance of, or benefits of using, products or technologies, updates or improvements of our products, intentions regarding seeking regulatory approval for our products, competition, expectations regarding unrecognized income tax benefits, expectations regarding the impact of an increase in market rates on the value of our investment portfolio, the sufficiency of cash, cash equivalents and investments to fund projected operating requirements, the effects of recent accounting pronouncements on our financial statements and other future events. Such statements may be signified by terms such as “anticipates,” “believes,” “could,” “estimates,” “expects,” “intends,” “may,” “plans,” “potential,” “predicts,” “projects,” “seeks,” “should,” “target,” “will,” and the negatives of those terms. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading “Risk Factors” in this report and in other documents we file with the Securities and Exchange Commission (“SEC”). Given these risks and uncertainties, you should not place undue reliance on forward-looking statements. Also, forward-looking statements represent management’s beliefs and assumptions as of the date of this report. Except as required by law, we assume no obligation to update forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

ITEM 1. BUSINESS

Overview

We design, develop and manufacture sequencing systems to help scientists resolve genetically complex problems. Based on our novel Single Molecule, Real-Time (SMRT®) sequencing technology, our products enable: de novo genome assembly to finish genomes in order to more fully identify, annotate and decipher genomic structures; full-length transcript analysis to improve annotations in reference genomes, characterize alternatively spliced isoforms in important gene families, and find novel genes; targeted sequencing to more comprehensively characterize genetic variations; and real-time kinetic information for epigenome characterization. Our technology provides high accuracy, ultra-long reads, uniform coverage, and is the only DNA sequencing technology that provides the ability to simultaneously detect epigenetic changes. PacBio® sequencing systems, including consumables and software, provide a simple, fast, end-to-end workflow for SMRT sequencing.

Our customers and our scientific collaborators have published numerous peer-reviewed articles in journals including Nature, Science, Cell, PNAS and The New England Journal of Medicine highlighting the power and applications of SMRT sequencing in projects such as finishing genomes, structural variation discovery, isoform transcriptome characterization, rare mutation discovery and the identification of chemical modifications of DNA related to virulence and pathogenicity. Our research and development efforts are focused on developing new products and further improving our existing products, including continuing chemistry and sample preparation improvements to increase throughput and expand our supported applications. By providing access to genetic information that was previously inaccessible, we enable scientists to confidently increase their understanding of biological systems.

Pacific Biosciences of California, Inc., formerly Nanofluidics, Inc., was incorporated in the State of Delaware in 2000. Our executive offices are located at 1305 O'Brien Drive, Menlo Park, California 94025, and our telephone number is (650) 521-8000.

The Underlying Science

Genetic inheritance in living systems is conveyed through a naturally occurring information storage system known as deoxyribonucleic acid, or DNA. DNA stores information in linear chains of the chemical bases adenine, cytosine, guanine and thymine, represented by the symbols A, C, G and T respectively. Inside living cells, these chains usually exist in pairs bound together in a double helix by complementary bases, with A of one strand always binding to a T of the other strand and C always binding to G.

In humans, there are approximately three billion DNA base-pairs in the molecular blueprint of life, called the genome. These three billion bases are divided into 23 chromosomes ranging in size from 50 million to 250 million bases. Normally, there are two complete copies of the genome contained in each cell, one of maternal origin and the other of paternal origin. When cells divide, the genomes are replicated by an enzyme called DNA polymerase, which visits each base in the sequence, creating a complementary copy of each chromosome using building blocks called nucleotides. Contained within these chromosomes are approximately 23,000 smaller regions, called genes, each one containing the recipe for a protein or group of related proteins. The natural process of protein production takes place in steps. In a simplified model, the first step is transcription, a process in which an enzyme called RNA polymerase uses

DNA as a template to synthesize new strands of messenger RNA, or mRNA. The mRNAs are then translated into proteins by ribosomes. The resulting proteins go on to play crucial roles in cellular structure and function and thus the operation of biological systems.

Numerous scientific approaches have evolved to adapt to the emerging awareness of the magnitude of complexity embedded in biological systems. The field of genomics developed to study the interactions among components in the genome and the massive quantities of associated data. Subsequently, proteomics, transcriptomics and a number of other related fields emerged.

Advances in biology over the next decade are expected to be shaped by a more detailed understanding of the fundamental complexity of biological systems. These systems vary among individuals in previously unrecognized ways and are influenced by factors including time, molecular interactions, and cell type.

Importantly for the future of genomics, the first few whole-genome sequencing studies of disease have shown that rare mutations play a critical role in human disease. These mutations would not have been detected in earlier studies because too few people, or perhaps only one person, carry the specific mutation. In addition, it is now understood that structural changes to the genome in which whole sections are deleted, inverted, copied or moved may be responsible for a significant fraction of variation among individuals. The scope of these structural changes challenges the very idea of a reference genome.

Recent discoveries have highlighted additional complexities in the building blocks of DNA and RNA, including the presence of modified bases. It has long been known that in humans and many other organisms, the cytosine bases can be chemically modified through the addition of a methyl group in a process called methylation, resulting in modified bases such as 5-methylcytosine (5-mC) and N4-methylcytosine (4-mC). These chemical modifications have been shown to play a role in embryonic development, have important impacts on diseases such as cancer and can even affect the characteristics of offspring for multiple generations. More recently, it has been discovered that other modified bases, such as 5-hydroxymethylcytosine, 8-oxoguanine and many others, play important physiological roles. For example, in bacteria, N6-methyladenine (6-mA) has been shown to play an important role in pathogenicity.

Another source of complexity derives from the processing of RNA molecules after being transcribed from the genome. The majority of all genes code for different forms of a protein that can be made depending on the structure of the RNA molecule, referred to as splice variants. A detailed understanding of both the expression pattern and regulation of these variants is believed to play an important role in a number of critical biological processes.

Recent advances in our understanding of biological complexity have highlighted the need for advanced tools such as the PacBio® RS II System and the Sequel™ System to study DNA, RNA and proteins. In the field of DNA sequencing, incremental technological advances have provided novel insights into the structure and function of the genome. Despite these advances, scientists have not been able to fully characterize the human genome and the genomes of other living organisms because of inherent limitations in these tools.

Evolution of Sequencing

In order to understand the limitations of current DNA sequencing technologies, it is important to understand the sequencing process. This consists of three phases: sample preparation, physical sequencing, and analysis. The first step of sample preparation is to either break the target genome into multiple small fragments or, depending on the amount of sample DNA available, amplify the target region using a variety of molecular methods. In the physical sequencing phase, the individual bases in each fragment are identified in order, creating individual reads. The number of individual bases identified contiguously is defined as read length. In the analysis phase, bioinformatics software is used to align overlapping reads, which allows the original genome to be assembled into contiguous sequence. The longer the read length, the easier it is to assemble the genome.

Sanger Sequencing

The first automated sequencing methodology, often referred to as “Sanger sequencing,” was developed by Frederick Sanger in 1977. With this technology, during sample preparation, scientists first make different sized fragments of DNA each starting from the same location. Each fragment ends with a particular base that is labeled with one of four fluorescent dyes corresponding to that particular base. Then all of the fragments are distributed in order of their length by driving them through a gel. Information regarding the last base is used to determine the original sequence. Under standard conditions, this method results in a read length that is approximately 700 bases on average, but may be extended to 1,000 bases. These are relatively long read lengths compared with many next-generation sequencing methods. However, Sanger sequencing is limited by the small amounts of data that can be processed per unit of time, referred to as throughput.

Short-read Sequencing

Several commercial DNA sequencing tools emerged in 2005 in response to the low throughput of Sanger sequencing. Now commonly referred to as “short-read sequencing”, these methods achieve much higher throughput by sequencing a large number of DNA molecules in parallel, but with the tradeoff of shorter read lengths.

In most short-read sequencing methodologies, tens of thousands of identical strands are anchored to a given location to be read in a process consisting of successive flushing and scanning operations. The “flush and scan” sequencing process involves sequentially flushing in reagents, such as labeled nucleotides, incorporating nucleotides into the DNA strands, stopping the incorporation reaction, washing out the excess reagent, scanning to identify the incorporated base and finally treating that base so that the strand is ready for the next “flush and scan” cycle. This cycle is repeated until the reaction is no longer viable.

Due to the large number of flushing, scanning and washing cycles required, the time to result for short-read sequencing methods can be longer, sometimes taking days. This repetitive process also limits the average read length

produced by most of these systems under standard sequencing conditions to approximately 35 to 400 bases.

The short-read sequencing technologies require a large number of DNA molecules during the sequencing process. To generate enough DNA molecules, a copying method called PCR amplification is required during sample preparation. This amplification process can introduce errors known as amplification bias. The effect of this bias is that resulting copies are not uniformly representative of the original template DNA. In cases where the original template DNA contains regions of relatively high G-C content or relatively high A-T content, the PCR amplification process tends to under-represent these regions. As a result, these regions, which may contain entire genes, can be completely missed.

In summary, while short-read sequencing methods can offer very high throughput and low cost per identified base, their disadvantages can include limited read length, variation in sequence coverage with regard to representation bias and accuracy, dependence on amplification, long time to result, and/or a need for many samples to justify machine operation.

The PacBio Solution — Single Molecule, Real-Time Technology

We have developed our SMRT technology, which enables single molecule, real-time detection of biological processes, to address many of the limitations of previous sequencing technologies. By providing long read lengths, elimination of the dependence on amplification during sample preparation (which can result in amplification bias), very high consensus accuracy, and the ability to detect DNA base modifications, the PacBio RS II System and the Sequel System provide more comprehensive and higher quality information of DNA and RNA sequence as well as epigenetic regulation and DNA damage.

Pacific Biosciences' SMRT Technology

SMRT technology enables the observation of DNA synthesis as it occurs in real time by harnessing the natural process of DNA replication, which in nature is a highly efficient and accurate process actuated by the DNA polymerase. The DNA polymerase attaches itself to a strand of DNA to be replicated, examines the individual base at the point it is attached, and then determines which of four building blocks, or nucleotides, is required to complement that individual base. After determining which nucleotide is required, the polymerase incorporates that nucleotide into the growing strand being produced. After incorporation, the enzyme advances to the next base to be replicated and the process is repeated.

To overcome the challenges inherent in real-time observation of the natural activity of the DNA polymerase, an enzyme measuring approximately 15 nanometers (nm) in diameter, we offer three key innovations:

- The SMRT Cell
- Phospholinked nucleotides
- The PacBio RS II and Sequel instruments

The SMRT Cell

One of the fundamental challenges with observing a single DNA polymerase molecule working in real time is the ability to detect the incorporation of a single nucleotide, taken from a large pool of potential nucleotides, during DNA synthesis. To resolve this problem, we utilize our nanoscale innovation, the zero-mode waveguide, or ZMW.

The ZMWs in our SMRT Cells consist of holes in an opaque layer, measuring only tens of nanometers in diameter forming nanoscale wells. The small size of the ZMW causes the intensity of visible laser light, which has a wavelength of approximately 600nm, to decay exponentially in the ZMW. Therefore, laser light shined into the ZMW from below is blocked from reaching the sequencing solution above the ZMW, providing selective illumination of only the bottom portion of the nanoscale well. DNA polymerases are anchored to the bottom of the glass surface of the nanoscale wells using proprietary techniques. Nucleotides, each type labeled with a different colored fluorophore, are then flooded above an array of ZMWs at the required concentration. When the labeled nucleotides diffuse into the bottom portion of the nanoscale wells, which contain the anchored DNA polymerases, their fluorescence can be monitored. When the correct nucleotide is detected by the polymerase, it is incorporated into the growing DNA strand in a process that takes milliseconds in contrast to simple diffusion which takes microseconds. This difference in time results in higher signal intensity for incorporated versus unincorporated nucleotides, which creates a high signal-to-noise ratio. Thus, the ZMW provides the ability to detect a single incorporation event against the background of fluorescently labeled nucleotides at biologically relevant concentrations. Our DNA sequencing is performed on proprietary SMRT Cells, each having an array of ZMWs. The SMRT Cells for the PacBio RS II System each contain approximately 150,000 ZMWs, whereas the SMRT Cells for the Sequel System each contain approximately one million ZMWs. Each ZMW is capable of containing a DNA polymerase molecule bound to a single DNA template. Currently, our immobilization process randomly distributes polymerases into ZMWs across the SMRT Cell, resulting in approximately one-third of the ZMWs having a single template.

Phospholinked Nucleotides

Our proprietary phospholinked nucleotides have a fluorescent dye attached to the phosphate chain of the nucleotide rather than to the base. As a natural step in the synthesis process, the phosphate chain is cleaved when the nucleotide is incorporated into the DNA strand. Thus, upon incorporation of a phospholinked nucleotide, the DNA polymerase

naturally frees the dye molecule from the nucleotide when it cleaves the phosphate chain. Upon cleaving, the label quickly diffuses away, leaving a natural piece of DNA without evidence of labeling.

The PacBio RS II and Sequel Instruments

The PacBio RS II and Sequel instruments conduct, monitor, and analyze single molecule biochemical reactions in real time. The instruments use extremely sensitive imaging systems to collect the light pulses emitted by fluorescent reagents allowing the observation of biological processes. Computer algorithms are used to translate the information that is captured by the optics system. Using the recorded information, light pulses are converted into either an A, C, G or T base call with associated quality metrics. Once sequencing is started, the real-time data is delivered to the system's primary analysis pipeline, which outputs base identity and quality values, or QVs. To generate a consensus sequence from the data, an assembly process assembles the different fragments from each ZMW based on common sequences.

SMRT Sequencing Advantages

Sequencing based on our SMRT technology offers the following key benefits:

- Longer read lengths

SMRT technology has been demonstrated to produce read lengths that are significantly longer than those of previous sequencing technologies. Long read lengths are necessary to span repetitive regions to efficiently assemble genomes. Long

read lengths are an important factor in enabling a comprehensive view of the genome, as they can reveal multiple types of genetic variation such as structural variants.

- High consensus accuracy

Users of SMRT technology can achieve very high consensus accuracy due to the attributes of SMRT sequencing, including long read lengths, lack of reliance on amplification during sample preparation (which can result in amplification bias), and lower systematic bias. Users of short-read sequencing technologies often cannot achieve comparable results due to their shorter read lengths and systematic bias.

- More uniformity and less systematic error

The sample preparation step for SMRT sequencing is compatible with but does not require amplification; when amplification is not used during sample preparation, the reads are not subject to amplification bias. Importantly, this allows for uniform identification of all bases present in a DNA sample and uniform sequence coverage. As a result, SMRT sequencing can detect and identify regions and entire genes that may be missed by short-read sequencing technologies.

- Ability to observe and capture kinetic information

The ability to observe the activity of a DNA polymerase in real time enables the PacBio RS II and Sequel Systems to collect, measure and assess the dynamics and timing of nucleotides being added to a growing DNA strand, referred to as kinetics. It is well established in the scientific community that chemical modification of DNA such as the addition of a methyl group, known as methylation, can alter the biological activity of the affected nucleotide. The PacBio RS II and Sequel Systems detect changes in kinetics automatically by capturing and recording changes in the duration of, and time period between, each of the fluorescent pulses during a typical sequencing analysis. Integrated software can then translate these kinetic signatures into uniquely characterized modified bases such as 6-mA, 4-mC and 5-mC. Other sequencing systems, which rely on a sample preparation amplification step or are limited by signal resolution, are unable to directly measure this type of kinetic data.

- Flexibility

Our sequencing systems have the ability to scale the throughput and cost of sequencing across a range of small to large projects. They can be used with a variety of sample types and can output a range of DNA lengths.

Our Products

We entered the market with our first commercial product, the PacBio RS System, during the second quarter of 2011 and launched the higher performance PacBio RS II System during the second quarter of 2013. In September of 2015, we announced the Sequel System, which is based on the same underlying SMRT technology as the PacBio RS II System, but can achieve up to approximately seven times the throughput with newly-designed SMRT Cells. Our sequencing systems provide access to a wide range of applications and are designed for expandable improvements to performance capability and new application capabilities through chemistry and software enhancements without necessitating changes to instrument hardware.

PacBio Systems

The PacBio RS II and Sequel Systems conduct, monitor, and analyze biochemical sequencing reactions. The PacBio RS II and Sequel instruments are integrated units that include high performance optics, automated liquid handling, a touchscreen control interface and computational hardware and software. Each instrument's high performance optics monitor the ZMWs in a SMRT Cell in real time. The automated liquid handling system performs reagent mixing and

prepares SMRT Cells. Each instrument's touchscreen control interface is the user's primary control center to design and monitor experiments. The computational hardware and software in each instrument is responsible for processing the sequencing data produced by the SMRT Cells. Both the PacBio RS II System and the Sequel System have been designed to allow for performance improvements to be easily integrated into the systems.

Consumables

Customers must purchase proprietary consumable products to run either the PacBio RS II System or Sequel System. Our consumable products include our proprietary SMRT Cells and reagent kits. One SMRT Cell is consumed per sequencing reaction, and scientists can choose the number of SMRT Cells they use per experiment. For the PacBio RS II instrument, eight SMRT Cells containing approximately 150,000 ZMWs each are individually and hermetically sealed then packaged together into a streamlined 8Pac format. Sequel System customers purchase a similarly packaged, four SMRT Cell format with approximately one million ZMWs each.

We offer several reagent kits, each designed to address a specific step in the workflow. A template preparation kit is used to convert DNA into SMRTbell™ double-stranded DNA library formats and includes typical molecular biology reagents, such as ligase, buffers and exonucleases. Our binding kits include our modified DNA polymerase, and are used to bind SMRTbell libraries to the polymerase in preparation for sequencing. Our sequencing kits contain reagents required for on-instrument, real-time sequencing, including the phospholinked nucleotides.

Product Enhancements

Since the introduction of our products in 2011, we have continued to significantly enhance the performance of PacBio sequencing systems through a combination of sample preparation protocol enhancements, software releases, and new sequencing reagent chemistries. By providing an increasing number of longer reads per instrument run, the new chemistries have enabled users to assemble more genomes to a high quality. We have continually improved our software to expand the number of supported applications such as large genome assembly, sequencing of transcript isoforms produced from genes, and phasing of haplotypes in large amplicons. During 2017, we plan to further improve our existing products, including chemistry and sample preparation improvements to increase throughput and expand our supported applications, and to continue to develop new products.

Market for Our Products

Our customers use our products for sequencing genomes and transcriptomes across a wide range of organisms. Initially, customers in research, government and commercial markets used the PacBio RS and RS II Systems to generate more complete assemblies of small and medium size genomes, such as bacteria and fungi, and for sequencing targeted regions of larger genomes such as humans and plants. As throughput and read lengths have increased, the complexity and size of genomes being resolved with SMRT sequencing have grown. Scientists now use SMRT sequencing to generate genome assemblies of humans, plants & animals, characterize transcriptomes through full-length isoform sequencing, and phase complex genomic regions like full-length human leukocyte antigen, or HLA, genes. With the introduction of the Sequel System, our higher throughput and lower cost platform for SMRT sequencing, we anticipate increasing both mindshare and market share within research and commercial markets such as human biomedical research, plant and animal sciences, microbiology & infectious disease, and immunogenomics.

There are a number of emerging markets for sequencing-based tests, including molecular diagnostics, which represent significant potential opportunities for our products. The development of these markets is subject to variability driven by ongoing changes in the competitive landscape, evolving regulatory requirements, government funding of research and development activities, and macroeconomic conditions. Introductions of new technologies and products, while positive to the overall development of these markets, may result in greater competition for the limited financial resources available. As we continue to expand into these emerging markets, the development of our business will be impacted by the variability of the factors affecting the growth of these markets.

Pacific Biosciences' Strategy

Key elements of our strategy include:

- Offer differentiated products based on our proprietary SMRT technology

Our SMRT technology provides a window into biological processes that has not previously been available. The combination of our products' and underlying SMRT technology's ability to deliver long read lengths, high consensus accuracy, low bias, and kinetic information affords the scientific community a new tool to conduct research not possible with other sequencing technologies.

- Enhance product performance and introduce new products to increase market share.

The design of our sequencing systems allows for significant performance improvements. Our flexible platforms are designed to generate a recurring revenue stream through the sale of proprietary SMRT Cells and reagent kits. With the introduction of the Sequel System, our higher throughput and lower cost platform for SMRT sequencing, we anticipate increasing both market recognition and market share within the markets for our products. We plan to introduce additional product enhancements over time to further reduce DNA sequencing project costs and time to

result while expanding application solutions.

- Create a global community of users to enhance informatics capabilities, develop sample preparation solutions, and drive adoption of our products in new application and market areas.

We work closely with our customers and collaborators to develop new applications and demonstrate SMRT sequencing capabilities on scientifically relevant projects. We partner with members of the informatics community to develop and define standards for working with single molecule, real-time sequence data. We maintain the PacBio DevNet site, a website on which we make available various software tools and information about our SMRT sequencing technology to support academic informatics developers, scientists and independent software vendors interested in creating tools to work with SMRT sequencing data. This gives the user flexibility to perform further analysis of the sequencing data through third-party software or share data with collaborators. To help maximize the flexibility and functionality for users, our secondary analysis algorithms are made available under open source licenses. We also make available on our main corporate website various methods developed internally and externally for simplifying and enhancing sample preparation protocols.

- Leverage SMRT technology and community engagement to expand application capabilities and penetrate new markets.

We plan to leverage our customers' successes with SMRT sequencing to expand the capabilities of our products for applications our customers have identified as high-value based on the differentiating attributes of our technology. Early applications identified by our customers include: whole genome sequencing, targeted sequencing of complex regions, isoform discovery and characterization, resolution of complex populations, and epigenetic analysis. We plan to develop whole product

solutions around these applications, making it easier for customers who are not typically early adopters of new technology to take advantage of SMRT sequencing.

In the long term, we believe that our SMRT technology may also be adapted for RNA transcription monitoring, direct RNA sequencing, protein translation and ligand binding. We believe these applications can create substantial new markets for our technology.

Marketing, Sales, Service and Support

We market our products through a direct sales force in North America and Europe and primarily through distribution partners in Asia and parts of the Middle East and Latin America. Our sales strategy involves the use of a combination of sales personnel and field application scientists. The role of our sales personnel is to educate customers on the advantages of SMRT technology and the applications that our technology makes possible. The role of our field application scientists is to provide on-site training and scientific technical support to prospective and existing customers. Our field application scientists are technical experts, often with advanced degrees, and generally have extensive experience in academic research and core sequencing lab experience.

Service for our instruments is performed by field service engineers. These field service engineers are trained by experienced personnel to test, trouble-shoot, and service instruments installed at customer sites.

In addition, we maintain an applications lab team in Menlo Park, California composed of scientific experts who can transfer knowledge from the research and development team to the field application scientists. The applications lab team also runs foundational scientific collaborations and proof of principle studies, which help demonstrate the value of our product offering to prospective customers.

Customers

Our customers include research institutions, commercial laboratories, genome centers, clinical, government and academic institutions, genomics service providers, pharmaceutical companies and agricultural companies. In general, our customers will isolate, prepare and analyze genetic samples using PacBio sequencing systems in their own research labs to address their specific applications and scientific questions. For example, customers in academic research institutions may have bacteria, animal, or human DNA samples isolated from various sources while agricultural biology companies may have DNA samples isolated from different strains of rice, corn or other crops. For the years ended December 31, 2016, 2015 and 2014, excluding contractual revenue, no single end customer accounted for more than 10% of our total revenue.

We believe that the majority of our current customers are early adopters of sequencing technology. By focusing our efforts on high-value applications, and developing whole product solutions around these applications, we seek to drive the adoption of our products across a broader customer base and into numerous large-scale projects. In general, the broader adoption of new technologies by mainstream customers can take a number of years.

We currently sell our products to a number of customers outside the United States, including customers in other areas of North America, Europe, Asia, the Middle East, and Latin America. Roche related contractual revenue has been classified as revenue from the United States. Revenue from customers outside the United States totaled \$41.0 million, or 45% of our total revenue during fiscal 2016, compared to \$24.9 million, or 27% of our total revenue, during fiscal 2015, and compared to \$26.2 million, or 43% of our total revenue, during fiscal 2014.

Backlog

As of December 31, 2016, our instrument backlog was approximately \$11.0 million, compared to \$16.7 million as of December 31, 2015. We define backlog as purchase orders or signed contracts from our customers which we believe are firm and for which we have not yet recognized revenue. We expect to convert this backlog to revenue during 2017; however, our ability to do so is subject to customers who may seek to cancel or delay their orders even if we are prepared to fulfill them.

Manufacturing

Until recently, our principal manufacturing activities have been performed at our prior campus in Menlo Park, California. We are in the process of moving our manufacturing activities to our new headquarters, also in Menlo park, the O'Brien Premises. We currently perform some of the manufacturing and all of the final integration of our instruments in-house, while outsourcing most sub-assemblies to third-party manufacturers. With respect to the manufacture of SMRT Cells, we subcontract wafer fabrication and processing to semiconductor processing facilities, but conduct critical surface treatment processes internally. In addition, we currently manufacture critical reagents in-house, including our phospholinked nucleotides and our DNA polymerase.

We purchase both custom and off-the-shelf components from a large number of suppliers and subject them to significant quality specifications. We periodically conduct quality audits of most critical suppliers and have established a supplier certification program. We purchase components through purchase orders. Some of the components required in our products are currently either sole sourced or single sourced.

Research and Development

Our SMRT technology requires the blending of a number of unique disciplines, namely nanofabrication, physics, photonics, optics, molecular biology, engineering, signal processing, high performance computing, and bioinformatics. Our research and development team is a blend of these disciplines creating a single, cross-functional /operating unit. We have also established productive working relationships with technology industry leaders, as well as leading academic centers, to augment and complement our internal research and development efforts. Research and development expenses incurred were \$67.6 million, \$60.4 million and \$48.2 million during 2016, 2015 and 2014, respectively. We plan to continue our investment in research and development to enhance the performance and expand the application of our current products, and introduce additional products based on our SMRT technology. Our goals include further improvements in sequencing read length and mappable data per SMRT Cell, chemistry and software enhancements, and enhancements in sample preparation and bioinformatics tools that take advantage of the capabilities of our products. In addition, our engineering teams will continue their focus on increasing instrument component and system reliability, reducing costs, and implementing additional system flexibility and versatility through the enhancement of existing products and development of new products.

Intellectual Property

Developing and maintaining a strong intellectual property position is an important element of our business. We have sought, and will continue to seek, patent protection for our SMRT technology, for improvements to our SMRT technology, as well as for any of our other technologies where we believe such protection will be advantageous.

Our current patent portfolio, including patents exclusively licensed to us, is directed to various technologies, including SMRT nucleic acid sequencing and other methods for analyzing biological samples, ZMW arrays, surface treatments, phospholinked nucleotides and other reagents for use in nucleic acid sequencing, optical components and systems, processes for identifying nucleotides within nucleic acid sequences and processes for analysis and comparison of nucleic acid sequence data. Some of the patents and applications that we own, as well as some of the patents and applications that we have licensed from other parties, are subject to U.S. government march-in rights, whereby the U.S. government may disregard our exclusive patent rights on its own behalf or on behalf of third parties by imposing licenses in certain circumstances, such as if we fail to achieve practical application of the U.S. government funded technology, because action is necessary to alleviate health or safety needs, to meet requirements of federal regulations, or to give preference to U.S. industry. In addition, U.S. government funded inventions must be reported to the government and U.S. government funding must be disclosed in any resulting patent applications.

As of December 31, 2016, we own or hold exclusive licenses to 221 issued U.S. patents, 106 pending U.S. patent applications, 133 granted foreign patents and 81 pending foreign patent applications, including foreign counterparts of U.S. patent and patent applications. The full term of the issued U.S. patents will expire between 2019 and 2034. We also have non-exclusive patent licenses with various third parties to supplement our own large and robust patent portfolio.

Of our exclusively licensed patent applications, 20 issued U.S. patents, one pending U.S. patent application, 14 granted foreign patents and one pending foreign patent application are licensed to us by the Cornell Research Foundation, which manages technology transfers on behalf of Cornell University. We have also entered into a license agreement with Indiana University Research and Technology Corporation, or IURTC, for U.S. Patent No. 6,399,335, which relates to nucleoside triphosphates that include a labeling group attached through the terminal phosphate group in the triphosphate chain. We have also entered into a license agreement with GE Healthcare Bio-Sciences Corp, or GE Healthcare, for several U.S. and foreign patents and pending patent applications related to labeled nucleoside polyphosphate compounds.

In September 2013, we entered into a Development, Commercialization and License Agreement (the “Roche Agreement”) with F. Hoffman-La Roche Ltd (“Roche”), pursuant to which we: (i) had been developing diagnostic products for clinical use including sequencing systems and consumables based on our proprietary SMRT technology; (ii) had agreed to grant to Roche an exclusive right to commercialize, and an exclusive license to sell, the developed diagnostic products for clinical use; and (iii) had agreed to manufacture and supply certain products intended for clinical use as the exclusive supplier to Roche. We received a non-refundable up-front payment of \$35.0 million in 2013, and milestone payments totaling \$40.0 million in 2014 and 2015 pursuant to the Roche Agreement. No further milestone payments are expected under the Roche Agreement. On December 12, 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience, and the termination became effective on February 10, 2017, which was 60 days after the date of the notice required under the Roche Agreement.

On November 2, 2016, we filed a complaint against Oxford Nanopore Technologies Ltd., Oxford Nanopore Technologies, Inc. and Metrichor, Ltd. (together, “ONT”) with the U.S. International Trade Commission (“USITC”) for patent infringement. On December 5, 2016, the USITC provided notice that an investigation had been instituted based on the complaint. We are seeking exclusionary relief with respect to several ONT products, including ONT’s MinION and PromethION devices. The complaint is based on our U.S. Patent No. 9,404,146, entitled “Compositions and methods for nucleic acid sequencing” which covers novel methods for sequencing single nucleic acid molecules using linked double-stranded nucleic acid templates, providing improved sequencing accuracy. On March 1, 2017, we filed an amended complaint to add a second patent in the same patent family, U.S. Patent No. 9,542,527, which was granted on January 10, 2017, to the investigation. We are seeking, among other things, an exclusion order permanently barring entry of infringing ONT products into the United States, and a cease and desist order preventing ONT from advertising and selling infringing products in the United States.

On February 2, 2017, we filed a claim in the High Court of England and Wales against Oxford Nanopore Technologies Ltd. and Metrichor, Ltd. for infringement of Patent EP(UK) 3 025 542, which is in the same patent family as the patents asserted in the USITC action referred to above. We are seeking remedies including injunctive relief, damages, and costs.

Where patent protection is difficult to obtain or difficult to enforce for a particular technological development or the technological development derives greater value from being maintained as confidential information, we seek to protect such information as trade secrets.

Competition

Given the market opportunity, there are a significant number of competing companies offering DNA sequencing equipment or consumables. These include Illumina, Inc. and Thermo Fisher Scientific, Inc. These companies currently have greater financial, technical, research and/or other resources than we do. They also have larger and more established manufacturing capabilities and marketing, sales and support functions. We expect the competition to intensify within this market as there are also several companies in the process of developing new, potentially competing technologies, products and/or services, including Oxford Nanopore Technologies Ltd. Increased competition may result in pricing pressures, which could harm our sales, profitability or market share.

In order for us to successfully compete against these companies, we will need to demonstrate that our products deliver superior performance and value as a result of our key differentiators, including single molecule, real-time resolution, the combination of very high consensus accuracy and long read lengths with the ability to detect real-time kinetic information, fast time to result and flexibility, as well as the breadth and depth of current and future products and applications.

Employees

As of December 31, 2016, we had 438 full-time employees. Of these employees, 159 were in research and development, 98 were in operations, 125 were in marketing, sales, service and support, and 56 were in general and administration. With the exception of our field-based sales and service teams, substantially all of our employees are located at our headquarters in Menlo Park, California. None of our employees are represented by labor unions or are covered by a collective bargaining agreement with respect to their employment. We have not experienced any work stoppages, and we consider our relationship with our employees to be good.

Available Information

Our website is located at www.pacb.com. The information posted on our website is not incorporated into this Annual Report on Form 10-K. Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge through the “Investors” section of our website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Additionally, we use our website as a channel of distribution for important company information. Important information, including press releases, analyst presentations and financial information regarding us, as well as corporate governance information, is routinely posted and accessible on the “Investor Relations” section of the website, which is accessible by clicking on the tab labeled “About Us - Investors” on our website home page. In addition, important information is routinely posted and accessible on the blog section of our website, which is accessible by clicking on the tab labeled “Blog” on our website home page, as well as our Twitter account (@pacbio). Information on or that can be accessed through our website or our Twitter account is not part of this Annual Report on Form 10-K,

and the inclusion of our website address is an inactive textual reference only.

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ITEM 1A. RISK FACTORS

You should consider carefully the risks and uncertainties described below, together with all of the other information in this Annual Report on Form 10-K, which could materially affect our business, financial condition, results of operations and prospects. The risks described below are not the only risks facing us. Risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially affect our business, financial condition, results of operations and prospects.

Risks Related to Our Business

We have limited experience as a commercial company.

Our first commercial product launched in 2011 and we have had limited sales to date. As such, we have limited historical financial data upon which to base our projected revenue, planned operating expenses or upon which to evaluate our company and our commercial prospects. Furthermore, in September 2015, we launched a new nucleic acid sequencing platform, the PacBio Sequel™ System. Based on our limited experience in developing and marketing our existing products and launching new products, we may not be able to effectively:

- drive adoption of our current and future products, including the Sequel System;
 - attract and retain customers for our products;
- provide appropriate levels of customer training and support for our products;
- implement an effective marketing strategy to promote awareness of our products;
- develop, manufacture and commercialize new products or achieve an acceptable return on our manufacturing or research and development efforts and expenses;
- comply with regulatory requirements applicable to our products;
- anticipate and adapt to changes in our market;
- accommodate customer expectations and demands with respect to our products, increase product adoption by our existing customers or develop new customer relationships;
- grow our market share by marketing and selling our products to new and additional market segments;
- maintain and develop strategic relationships with vendors and manufacturers to acquire necessary materials for the production of our existing or future products;
- adapt or scale our manufacturing activities to meet potential demand at a reasonable cost;
- avoid infringement and misappropriation of third-party intellectual property;
- obtain any necessary licenses to third-party intellectual property on commercially reasonable terms;
 - obtain valid and enforceable patents that give us a competitive advantage or enforce existing patents;
- protect our proprietary technology; and
- attract, retain and motivate qualified personnel.

The risks noted above, especially with respect to the marketing, sales, and commercialization of our products into the markets that Roche would have addressed under the Roche Agreement, may be heightened by the recent termination of the Roche Agreement. In addition, a high percentage of our expenses is and will continue to be fixed. Accordingly, if we do not generate revenue as and when anticipated, our losses may be greater than expected and our operating results will suffer.

We have incurred losses to date, and we expect to continue to incur significant losses as we develop our business and may never achieve profitability.

We have incurred net losses since inception and we cannot be certain if or when we will produce sufficient revenue from our operations to support our costs. While we achieved profitability for the quarter ended September 30, 2015, this result was largely due to a one-time gain on lease amendments. We have incurred net losses for all other fiscal periods, and, even if profitability is achieved in the future, we may not be able to sustain profitability on a consistent basis. We expect to continue to incur substantial losses and negative cash flow from operations for the foreseeable future.

If our products fail to achieve and sustain sufficient market acceptance, we will not generate expected revenue and our business may not succeed.

We cannot be sure that our current or future products will gain acceptance in the marketplace at levels sufficient to support our costs. Our success depends, in part, on our ability to expand the market for genetic analysis to include new applications that are not practicable with other current technologies. To accomplish this, we must successfully commercialize, and continue development of, our

proprietary Single Molecule, Real-Time (SMRT®) Sequencing technology for use in a variety of life science and other applications, including uses by academic, government and clinical laboratories, as well as pharmaceutical, diagnostic, biotechnology and agriculture companies, among others. There can be no assurance that we will be successful in securing additional customers for our products. For example, we have limited experience commercializing and selling products outside of the academic and research settings, and we cannot assure you that we can successfully acquire additional customers in additional markets. Furthermore, we cannot guarantee that our products will be satisfactory to potential customers in the markets we seek to reach. These markets are new and dynamic, and there can be no assurance that they will develop as quickly as we anticipate, that they will reach their full potential or that they will be receptive to our most recently-launched product, the Sequel System. As a result, we may be required to refocus our marketing efforts, and we may have to make changes to the specifications of our products to enhance our ability to enter particular markets more quickly. Even if we are able to implement our technology successfully, we and/or our sales and distribution partners may fail to achieve or sustain market acceptance of our current or future products across the full range of our intended life science and other applications. Given the loss of Roche as a partner, we may need to either expand our internal capabilities or collaborate with other partners, or both, in order to successfully expand sales of our products in the markets we seek to reach, including the markets that Roche would have addressed under the Roche Agreement, which we may be unable to do at the scale required to support our business. If the market for our products grows more slowly than anticipated, if we are unable to successfully scale or otherwise ensure sufficient manufacturing capacity for new products to meet demand, if we are not able to successfully market and sell our products, if competitors develop better or more cost-effective products, or if we are unable to further grow our customer base or do not realize the growth with existing customers that we are expecting, our current and future sales and revenue would be materially harmed and our business may not succeed.

If we are unable to successfully develop and timely manufacture our products, including Sequel Systems and related consumables, our business may be adversely affected.

In light of the highly complex technologies involved in our products, there can be no assurance that we will be able to manufacture and commercialize our new products on a timely basis or continue providing adequate support for our existing products. The commercial success of our products, including the Sequel System, depends on a number of factors, including performance and reliability of the system, our anticipating and effectively addressing customer preferences and demands, the success of our sales and marketing efforts, effective forecasting and management of product demand, purchase commitments and inventory levels, effective management of manufacturing and supply costs, and the quality of the Sequel System, including related consumables such as SMRT Cells and reagents. Should we face delays in or discover unexpected defects during the further development or manufacturing process of Sequel System instruments or consumables, including any delays or defects in software development or product functionality, the timing and success of the rollout and scaling of the Sequel System may be significantly impacted, which may materially and negatively impact our revenue and gross margin. The ability of our customers to successfully utilize the Sequel System will also depend on our ability to deliver high quality SMRT Cells and reagents. We have designed new SMRT Cells and other consumables for the Sequel System, and have recently transferred production of the new SMRT Cells from a prototype chip vendor to a high-volume manufacturer. Our production of the new SMRT Cells has previously been and may in the future be below desired levels, and we have experienced and may experience in the future manufacturing delays, product or quality defects, SMRT Cell variability and other issues, including unanticipated delays and other issues in connection with our transition to the high-volume manufacturer, any of which could negatively impact our ability to sell Sequel Systems or result in other material adverse effects on our business, financial condition and results of operations.

The development of our products is complex and costly. Problems in the design or quality of our products may have a material and adverse effect on our brand, business, financial condition, and operating results, and could result in us losing our certifications from the International Organization for Standardization (“ISO”). If we were to lose ISO certification, then our customers might choose not to purchase products from us and this could adversely impact our

ability to develop products approved for clinical uses. Unanticipated problems with our products could divert substantial resources, which may impair our ability to support our new and existing products, and could substantially increase our costs. If we encounter development challenges or discover errors in our products late in our development cycle, we may be forced to delay product shipments or the scaling of manufacturing or supply. In particular, if the continued rollout of the Sequel System is not successful, we may not be able to achieve an acceptable return, if any, on our substantial research and development efforts, and our business may be materially and adversely affected. The expenses or losses associated with delayed or unsuccessful product development or lack of market acceptance of our new products could materially and adversely affect our business, financial condition and results of operations.

Our research and development efforts may not result in the benefits we anticipate, and our failure to successfully market, sell, and commercialize our current and future products could have a material adverse effect on our business, financial condition and results of operations.

We have dedicated significant resources to developing our current products, including sequencing systems and consumables based on our proprietary SMRT sequencing technology and our Sequel System. We are also engaged in substantial and complex research and development efforts, which, if successful, may result in the introduction of new products in the future. Our research and development efforts are complex and require us to incur substantial expenses. We may not be able to develop and commercialize new products, obtain regulatory approval if necessary, or achieve an acceptable return, if any, on our research and development efforts and

expenses. There can also be no assurance that we will be able to develop and manufacture future products as a result of our research and development efforts, or that we will be able to market, sell and commercialize the products that result from our research and development efforts. Furthermore, in December 2016, Roche elected to terminate the Roche Agreement, and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. We may therefore need to expand our internal capabilities or seek new partnerships or collaborations, or both, in order to successfully market, sell and commercialize the products that we have developed in the markets we seek to reach, including the markets that Roche would have addressed under the Roche Agreement.

We must successfully manage new product introductions and transitions, we may incur significant costs during these transitions, and they may not result in the benefits we anticipate.

If our products and services fail to deliver the performance or results expected by our current and future customers, or are not delivered on a timely basis, our reputation and credibility may suffer, our current and future sales and revenue may be materially harmed and our business may not succeed. For instance, if we are not able to realize the benefits we anticipate from the development and commercialization of the Sequel System or our future products, including those that may be developed for clinical uses, it could have a material adverse effect on our business, financial condition and results of operations. In addition, the introduction of future products may lead to our limiting or ceasing development of further enhancements to our existing products as we focus our resources on new products, and could result in reduced marketplace acceptance and loss of sales of our existing products, materially adversely affecting our revenue and operating results. The introduction of new products, such as the Sequel System, may also have a negative impact on our revenue in the near-term as our current and future customers may delay or cancel orders of existing products in anticipation of new products and we may also be pressured to decrease prices for our existing products. Further, we have in the past experienced, and could in the future experience difficulty in managing or forecasting customer reactions, purchasing decisions or transition requirements with respect to newly-launched products, such as the Sequel System. We could incur significant costs in completing the transitions, including costs of inventory write-downs of our products, as current or future customers transition to the new products. If we do not successfully manage these product transitions, our business, reputation and financial condition may be materially and adversely affected.

We rely on other companies for the manufacture of certain components and sub-assemblies and intend to outsource additional sub-assemblies in the future. We may not be able to successfully scale the manufacturing process necessary to build and test multiple products on a full commercial basis, which could materially harm our business.

Our products are complex and involve a large number of unique components, many of which require precision in manufacturing. The nature of our products requires customized components that are currently available only from a limited number of sources, and in some cases, single sources. We have chosen to source certain critical components from a single source, including suppliers for our SMRT Cells, reagents and instruments. Furthermore, we have recently transferred production of the SMRT Cells for our Sequel System from a prototype chip vendor to a high-volume manufacturer, and we have experienced and may in the future experience unanticipated delays and other issues in connection with such transition. If we are required to purchase these components from alternative sources, it could take several months or longer to qualify the alternative sources. If we are unable to secure a sufficient supply of these product components on a timely basis, or if these components do not meet our expectations or specifications for quality and functionality, our operations and manufacturing will be materially and adversely affected, we could be unable to meet customer demand and our business and results of operations may be materially and adversely affected.

The operations of our third-party manufacturing partners and suppliers could be disrupted by conditions unrelated to our business or operations or that are beyond our control, including but not limited to international trade restrictions or changes resulting from factors beyond our control. If our manufacturing partners or suppliers are unable or fail to fulfill their obligations to us for any reason, we may not be able to manufacture our products and satisfy customer

demand or our obligations under sales agreements in a timely manner, and our business could be harmed as a result. Our current manufacturing process is characterized by long lead times between the placement of orders for and delivery of our products. If we have received insufficient components to manufacture our products on a timely basis to meet customer demand, our sales and our gross margin may be adversely affected and our business could be materially harmed. If we are unable to reduce our manufacturing costs and establish and maintain reliable, high-volume manufacturing suppliers as we scale our operations, our business could be materially harmed.

We may be unable to consistently manufacture our instruments and consumable kits, including SMRT Cells, to the necessary specifications or in quantities necessary to meet demand at an acceptable cost.

In order to successfully generate revenue from our products, we need to supply our customers with products that meet their expectations for quality and functionality in accordance with established specifications. Our customers have previously experienced variability in the performance of our instruments and SMRT Cells. Moreover, we are manufacturing a new version of our SMRT Cells for the Sequel System, and are in the process of simultaneously moving our in-house manufacturing facilities and scaling up manufacturing capacity for our products. In connection with this process, we may experience delays, quality issues or other difficulties leading to customer dissatisfaction with our products. Our production of new SMRT Cells has initially been and may in the future be below desired levels and we have experienced and may experience in the future manufacturing delays, product or quality defects, SMRT

Cell variability and other issues, including in connection with our recent transfer of the production of our SMRT Cells to a high-volume manufacturer. There is no assurance that we will be able to manufacture our products so that they consistently achieve the product specifications and quality that our customers expect, including any products developed for clinical uses. Problems in the design or quality of our products may have a material adverse effect on our brand, business, financial condition, and operating results, and could result in us losing our ISO certifications. If we were to lose our ISO certification, then our customers might choose not to purchase products from us. There is also no assurance that we will be able to increase manufacturing yields and decrease costs, or that we will be successful in forecasting customer demand or manufacturing and supply costs. Furthermore, we may not be able to increase manufacturing to meet anticipated demand or may experience downtime in our existing or new manufacturing facilities. An inability to manufacture products and components that consistently meet specifications, in necessary quantities and at commercially acceptable costs, will have a negative impact, and may have a material adverse effect, on our business, financial condition and results of operations.

Rapidly changing technology in life sciences and diagnostics could make our products obsolete unless we continue to develop and commercialize new and improved products and pursue new market opportunities.

Our industry is characterized by rapid and significant technological changes, frequent new product introductions and enhancements and evolving industry standards. Our future success will depend on our ability to continually improve our products, to develop and introduce new products that address the evolving needs of our customers on a timely and cost-effective basis and to pursue new market opportunities. These new market opportunities may be outside the scope of our proven expertise or in areas where the market demand is unproven, and new products and services developed by us may not gain market acceptance. Our inability to develop and introduce new products and to gain market acceptance of the Sequel System and other new products could harm our future operating results. Unanticipated difficulties or delays in replacing existing products with new products or in commercializing the Sequel System or other new or improved products in sufficient quantities to meet customer demand could diminish future demand for our products and harm our future operating results.

Increased market adoption of our products by customers may depend on the availability of sample preparation and informatics tools, some of which may be developed by third parties.

Our commercial success may depend in part upon the development of sample preparation and software and informatics tools by third parties for use with our products. We cannot guarantee that third parties will develop tools that our current and future customers will find useful with our products. A lack of complementary sample preparation and informatics tools may impede the adoption of our products and may materially and adversely impact our business.

We operate in a highly competitive industry and if we are not able to compete effectively, our business and operating results will likely be harmed.

Some of our current competitors, including Illumina, Inc. and Thermo Fisher Scientific Inc., as well as other potential competitors, have greater name recognition, more substantial intellectual property portfolios, longer operating histories, significantly greater financial, technical, research and/or other resources, more experience in new product development, larger and more established manufacturing capabilities and marketing, sales and support functions, and/or more established distribution channels to deliver products to customers than we do. These competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer requirements. In light of these advantages, even if our technology is more effective than the products or service offerings of our competitors, current and potential customers might purchase competitive products and services instead of our products.

There are also several companies that are in the process of developing or have already developed new, potentially competing technologies, products and/or services, including Oxford Nanopore Technologies Ltd., against whom we have filed a complaint with the U.S. International Trade Commission for patent infringement. Roche is also developing potentially competing sequencing products through its acquisition of Genia Technologies. Increased competition may result in pricing pressures, which could harm our sales, profitability or market share. Our failure to further enhance our existing products and to introduce new products to compete effectively could materially and adversely affect our business, financial condition or results of operations.

We may be unable to successfully increase sales of our products.

Our ability to achieve profitability depends on our ability to attract customers for our current and future products, and we may be unable to effectively market or sell our products, or find appropriate partners to do so. To perform sales, marketing, distribution and customer support functions successfully, we face a number of risks, including:

- our ability to attract, retain and manage the sales, marketing and service personnel necessary to expand market acceptance for our technologies;
- availability of potential sales partners to sell our technologies, and our ability to attract and retain such sales partners;
- the time and cost of maintaining and growing a specialized sales, marketing and service force for a particular application, which may be difficult to justify in light of the revenue generated; and
- our sales, marketing and service force may be unable to execute successful commercial activities.

We have enlisted and may continue to enlist third parties to assist with sales, distribution and customer support. There is no guarantee that we will be successful in attracting desirable sales and distribution partners, that we will be able to enter into arrangements with such partners on terms favorable to us or that we will be able to retain such partners on a going forward basis. If our sales and marketing efforts, or those of any of our third-party sales and distribution partners, are not successful, our technologies and products may not gain market acceptance, which could materially impact our business operations.

We plan to raise additional financing to fund our existing operations. Equity and debt securities we issue may have rights senior to common stockholders and additional equity financing will dilute the holdings of current stockholders.

We plan to raise additional funds through public or private debt or equity financing. Additional funds may not be available on terms acceptable to us or at all, particularly in light of restrictions under our debt agreement. We have incurred and may further incur additional debt. Debt holders have rights senior to common stockholders to make claims on our assets and the terms of our existing debt agreement restrict certain activities, including our ability to pay dividends on our common stock. To the extent that we raise additional funds through the sale of our common stock, downward fluctuations in our stock price could adversely affect such fundraising efforts. Furthermore, fundraising through sales of additional shares of common stock or other equity securities will have a dilutive effect on our existing investors.

Our indebtedness could adversely affect our financial condition and prevent us from fulfilling our obligations.

Our net losses since inception and our expectation of incurring substantial losses and negative cash flow for the foreseeable future, combined with our existing indebtedness, could:

- make it more difficult for us to satisfy our obligations, including under our existing debt agreement;
- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to fund future working capital, capital expenditures, research and development and other business opportunities;
- require us to dedicate a substantial portion of our cash flow from operations to service payments on our indebtedness;
- increase the volatility of the price of our common stock;
- limit our flexibility to react to changes in our business and the industry in which we operate;
- place us at a competitive disadvantage to our competitors that have less or no indebtedness; and
- limit, along with the financial and other restrictive covenants in our indebtedness, among other things, our ability to borrow additional funds.

Our existing debt contains covenants which may adversely impact our business and our failure to comply with such covenants could cause our outstanding indebtedness to become immediately payable.

Our existing debt contains various affirmative and negative covenants, including restrictions on our and our subsidiaries' ability to incur additional indebtedness or liens on our assets. These covenants impose significant operating and financial restrictions on us, including restrictions on our ability to take certain actions that may be in our best interests.

A breach of any of the covenants contained in our debt could result in an event of default. If an event of default exists, debt holders could elect to declare all amounts outstanding under the debt to be immediately due and payable. If we are unable to repay our indebtedness when due and payable, debt holders could proceed against the collateral granted to them to secure such indebtedness. We have pledged substantially all of our property and interests in property, including our intellectual property, as collateral under our existing debt. If the debt holders accelerate the repayment

of our indebtedness, we may not have sufficient funds to make such repayment, which could have a material adverse effect on our liquidity and ability to conduct our business.

In addition, at the election of the holders representing a majority of the aggregate principal amount of the outstanding notes issued pursuant to our existing debt agreement, the holders may elect to receive 25% of the net proceeds from any financing that includes an equity component, including, without limitation, the sale or issuance of our common stock, options, warrants or other securities convertible or exchangeable for shares of our common stock, as partial payment of the notes. This right is subject to certain exceptions set forth in our existing debt agreement. To the extent we raise additional capital in the future through the sale of common stock under any future “at-the-market” offering or through other financing activities, we may be obligated, at the election of the holders of the notes, to pay 25% of the net proceeds from any such financing activities as partial payment of the notes.

Our products are highly complex, have recurring support requirements and could have unknown defects or errors, which may give rise to claims against us or divert application of our resources from other purposes.

Products using our SMRT sequencing technology are highly complex and may develop or contain undetected defects or errors. Our customers have in the past experienced reliability issues with our products, and we have only recently launched the Sequel System, such that support costs are difficult to predict. Despite testing, defects or errors may arise in our products, which could result in a failure

to maintain or increase market acceptance of our products, diversion of development resources, injury to our reputation and increased warranty, service and maintenance costs. New products or enhancements to our existing products in particular may contain undetected errors or performance problems that are discovered only after delivery to customers. If our products have reliability or other quality issues or require unexpected levels of support in the future, the market acceptance and utilization of our products may not grow to levels sufficient to support our costs and our reputation and business could be harmed. We generally ship our sequencing instruments with one year of service included in the purchase price with an option to purchase one or more additional years of service. We also provide a warranty for our consumables, which is generally limited to replacing, or at our option, giving credit for any consumable with defects in material or workmanship. Defects or errors in our products may also discourage customers from purchasing our products. The costs incurred in correcting any defects or errors may be substantial and could materially and adversely affect our operating margins. If our service and support costs increase, our business and operations may be materially and adversely affected.

In addition, such defects or errors could lead to the filing of product liability claims against us or against third parties who we may have an obligation to indemnify against such claims, which could be costly and time-consuming to defend and result in substantial damages. Although we have product liability insurance, any product liability insurance that we have or procure in the future may not protect our business from the financial impact of a product liability claim. Moreover, we may not be able to obtain adequate insurance coverage on acceptable terms. Any insurance that we have or obtain will be subject to deductibles and coverage limits. A product liability claim could have a serious adverse effect on our business, financial condition and results of operations.

We depend on the continuing efforts of our senior management team and other key personnel. If we lose members of our senior management team or other key personnel or are unable to successfully retain, recruit and train qualified scientists, engineers and other personnel, our ability to maintain and develop our products could be harmed and we may be unable to achieve our goals.

Our future success depends upon the continuing services of members of our senior management team and scientific and engineering personnel. In particular, our scientists and engineers are critical to our future technological and product innovations and we will need to hire additional qualified personnel. Our industry, particularly in the San Francisco Bay Area, is characterized by high demand and intense competition for talent, and the turnover rate can be high. We compete for qualified management and scientific personnel with other life science companies, academic institutions and research institutions, particularly those focusing on genomics. Our employees could leave our company with little or no prior notice and would be free to work for a competitor. If one or more of our senior executives or other key personnel were unable or unwilling to continue in their present positions, we may not be able to replace them easily or at all, and other senior management may be required to divert attention from other aspects of the business. In addition, we do not have "key person" life insurance policies covering any member of our management team or other key personnel. The loss of any of these individuals or any inability to attract or retain qualified personnel, including scientists, engineers and others, could prevent us from pursuing collaborations and materially and adversely affect our support of existing products, product development and introductions, business growth prospects, results of operations and financial condition.

A significant portion of our potential sales depends on customers' spending budgets that may be subject to significant and unexpected variation which could have a negative effect on the demand for our products.

Our instruments represent significant capital expenditures for our customers. Potential customers for our current or future products include academic and government institutions, genome centers, medical research institutions, clinical laboratories, pharmaceutical, agricultural, biotechnology, diagnostic and chemical companies. Their spending budgets can have a significant effect on the demand for our products. Spending budgets are based on a wide variety of factors, including the allocation of available resources to make purchases, funding from government sources which is highly

uncertain and subject to change, the spending priorities among various types of research equipment and policies regarding capital expenditures during economically uncertain periods. Any decrease in capital spending or change in spending priorities of our current and potential customers could significantly reduce the demand for our products. Any delay or reduction in purchases by potential customers or our inability to forecast fluctuations in demand could harm our future operating results.

Our business could be negatively impacted by changes in the United States political environment.

The recent presidential and congressional elections in the United States have resulted in significant uncertainty with respect to, and could result in changes in, legislation, regulation and government policy at the federal level, as well as the state and local levels. Any such changes could significantly impact our business as well as the markets in which we compete. Specific legislative and regulatory proposals discussed during election campaigns and more recently that might materially impact us include, but are not limited to, changes to spending priorities and potential reductions in research funding. To the extent changes in the political environment have a negative impact on us or on our markets, our business, results of operation and financial condition could be materially and adversely impacted in the future.

We may not be able to convert our orders in backlog into revenue.

Our backlog represents product orders from our customers that we have confirmed and for which we have not yet recognized revenue. We may not receive revenue from these orders, and the order backlog we report may not be indicative of our future revenue.

Many events can cause an order to be delayed or not completed at all, some of which may be out of our control. If we delay fulfilling customer orders or if customers reconsider their orders, those customers may seek to cancel or modify their orders with us. Customers may otherwise seek to cancel or delay their orders even if we are prepared to fulfill them. If our orders in backlog do not result in sales, our operating results may suffer.

Delivery of our products could be delayed or disrupted by factors beyond our control, and we could lose customers as a result.

We rely on third-party carriers for the timely delivery of our products. As a result, we are subject to carrier disruptions and increased costs that are beyond our control. Any failure to deliver products to our customers in a safe and timely manner may damage our reputation and brand and could cause us to lose customers. If our relationship with any of these third-party carriers is terminated or impaired or if any of these carriers are unable to deliver our products, the delivery and acceptance of our products by our customers may be delayed, which could harm our business and financial results. The failure to deliver our products in a safe and timely manner may harm our relationship with our customers, increase our costs and otherwise disrupt our operations.

We are, and may become, subject to governmental regulations that may impose burdens on our operations, and the markets for our products may be narrowed.

We are subject, both directly and indirectly, to the adverse impact of government regulation of our operations and markets. For example, export of our instruments may be subject to strict regulatory control in a number of jurisdictions. We have expanded and are continuing to expand the international jurisdictions into which we supply products, which increase the risks surrounding governmental regulations relating to our business. The failure to satisfy export control criteria or to obtain necessary clearances could delay or prevent shipment of products, which could materially and adversely affect our revenue and profitability. Moreover, the life sciences industry, which is expected to be one of the primary markets for our technology, has historically been heavily regulated. There are, for example, laws in several jurisdictions restricting research in genetic engineering, which may narrow our markets. Given the evolving nature of this industry, legislative bodies or regulatory authorities may adopt additional regulations that may adversely affect our market opportunities. Additionally, if ethical and other concerns surrounding the use of genetic information, diagnostics or therapies become widespread, there may be less demand for our products.

Our business is also directly affected by a wide variety of government regulations applicable to business enterprises generally and to companies operating in the life science industry in particular. Failure to comply with government regulations or obtain or maintain necessary permits and licenses could result in a variety of fines or other censures or an interruption in our business operations which may have a negative impact on our ability to generate revenue and the cost of operating our business. In addition, changes to laws and government regulations could cause a material adverse effect on our business as we will need to adapt our business to comply with such changes. For example, a governmental prohibition on the use of human in vitro diagnostics would adversely impact our commercialization of products on which we have expended significant research and development resources, which would in turn have a material adverse impact on our business and prospects.

Our products could become subject to regulation by the U.S. Food and Drug Administration or other domestic and international regulatory agencies, which could increase our costs and impede or delay our commercialization efforts,

thereby materially and adversely affecting our business and results of operations.

Our products are not currently subject to U.S. Food and Drug Administration (“FDA”) clearance or approval since they are not intended for use in the diagnosis or treatment of disease. However, in the future, certain of our products or related applications, such as those that may be developed for clinical uses, could be subject to FDA regulation, or the FDA’s regulatory jurisdiction could be expanded to include our products. Even where a product is exempted from FDA clearance or approval, the FDA may impose restrictions as to the types of customers to which we or our partners can market and sell our products. Such regulation and restrictions may materially and adversely affect our business, financial condition and results of operations. In the event that we fail to obtain and maintain necessary regulatory clearances or approvals for products that we develop for clinical uses, or if clearances or approvals for future products and indications are delayed or not issued, our commercial operations may be materially harmed. Furthermore, even if we are granted regulatory clearances or approvals, they may include significant limitations on the indicated uses for the product, which may limit the market for the product. We do not have experience in obtaining FDA approvals and no assurance can be given that we will be able to obtain or to maintain such approvals. Furthermore, any approvals that we may obtain can be revoked if safety or efficacy problems develop.

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Many countries have laws and regulations that could affect our products, such as 510(k) clearances, premarket approvals or CE Mark requirements, and failure to adhere to applicable statutory or regulatory requirements by us or our business partners would have a material adverse effect on our operations and financial condition. The number and scope of these requirements are increasing. Unlike many of our competitors, this is an area where we do not have expertise. We, or our other third-party sales and distribution partners, may not be able to obtain regulatory approvals in such countries or may incur significant costs in obtaining or maintaining our foreign regulatory approvals. In addition, the export by us of certain of our products, which have not yet been cleared for domestic commercial distribution, may be subject to FDA or other export restrictions. Any action brought against us for violations of these laws or regulations, even if successfully defended, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business.

Doing business internationally creates operational and financial risks for our business.

We currently conduct operations in various countries and jurisdictions, and continue to expand to new international jurisdictions. For example, in 2016, we started selling into several new countries directly and through distribution partners, including Mexico and Israel, where we or our distribution partners may be subject to additional regulations and increased diversion of management time and efforts. Conducting and launching operations on an international scale requires close coordination of activities across multiple jurisdictions and time zones and consumes significant management resources. If we fail to coordinate and manage these activities effectively, our business, financial condition or results of operations could be materially and adversely affected and failure to comply with laws and regulations applicable to business operations in foreign jurisdictions may also subject us to significant liabilities and other penalties. International operations entail a variety of other risks, including, without limitation:

- challenges in staffing and managing foreign operations;
- tariffs and other trade barriers;
- changes in social, political and economic conditions or in laws, regulations and policies governing foreign trade, manufacturing, development and investment both domestically as well as in the other countries and jurisdictions into which we sell our products, including as a result of the referendum held in the United Kingdom approving the separation of the United Kingdom as a member of the European Union;
- difficulties in obtaining export licenses or in overcoming other trade barriers and restrictions resulting in delivery delays;
- potential increases on tariffs or restrictions on trade generally; and
- significant taxes or other burdens of complying with a variety of foreign laws.

In conducting our international operations, we are subject to U.S. laws relating to our international activities, such as the Foreign Corrupt Practices Act of 1977, as well as foreign laws relating to our activities in other countries, such as the United Kingdom Bribery Act of 2010. Failure to comply with these laws may subject us to claims or financial and/or other penalties in the United States and/or foreign countries that could materially and adversely impact our operations or financial condition. These risks have become increasingly prevalent as we have expanded our sales into countries that are generally recognized as having a higher risk of corruption.

We face risks related to the current global economic environment, which could delay or prevent our customers from purchasing our products, which could in turn harm our business, financial condition and results of operations. The state of the global economy continues to be uncertain. The current global economic conditions and uncertain credit markets and concerns regarding the availability of credit pose a risk that could impact customer demand for our products, as well as our ability to manage normal commercial relationships with our customers, suppliers and creditors, including financial institutions. If the current global economic environment deteriorates, our business could be negatively affected.

Moreover, changes in the value of the relevant currencies may affect the cost of certain items required in our operations. Changes in currency exchange rates may also affect the relative prices at which we are able to sell products in the same market. Our revenue from international customers may be negatively impacted as increases in the U.S. dollar relative to our international customers' local currencies could make our products more expensive, impacting our ability to compete or as a result of financial or other instability in such locations which could result in decreased sales of our products. Our costs of materials from international suppliers may also increase as the value of the U.S. dollar decreases relative to their local currency. Foreign policies and actions regarding currency valuation could result in actions by the United States and other countries to offset the effects of such fluctuations. Such actions may materially and adversely impact our financial condition and results of operations.

Violations of complex foreign and U.S. laws and regulations could result in fines and penalties, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business and on our ability to offer our products and services in one or more countries, and could also materially affect our brand, our international growth efforts, our ability to attract and retain employees, our business, and our operating results. Even if we implement policies or procedures designed to ensure compliance with these laws and regulations, there can be no assurance that our distribution partners, our employees, contractors, or agents will not violate our policies and subject us to potential claims or penalties.

If we fail to comply with healthcare and other governmental regulations, we could face substantial penalties and our business, results of operations and financial condition could be adversely affected.

The products that we may develop for clinical uses may be highly regulated, and there can be no assurance that the regulatory environment in which we would operate will not change significantly and adversely in the future. Any arrangements with physicians, hospitals and clinics may expose us to broadly applicable fraud and abuse and other laws and regulations that may restrict the financial arrangements and relationships through which we market, sell and distribute our products and services. Our employees, consultants, and commercial partners may engage in misconduct or other improper activities, including non-compliance with regulatory standards and requirements. Federal and state healthcare laws and regulations that may affect our ability to conduct business, include, without limitation:

- federal and state laws and regulations regarding billing and claims payment applicable to products that we may develop for clinical uses, and regulatory agencies enforcing those laws and regulations;
- the federal Anti-Kickback Statute, which prohibits, among other things, any person from knowingly and willfully offering, soliciting, receiving or providing remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual for, or the purchase, order or recommendation of, any good or service for which payment may be made under federal healthcare programs;
- the federal False Claims Act, which prohibits, among other things, individuals or entities from knowingly presenting, or causing to be presented, false claims, or knowingly using false statements, to obtain payment from the federal government;
- federal criminal laws that prohibit executing a scheme to defraud any healthcare benefit program or making false statements relating to healthcare matters;
- the FCPA, the U.K. Bribery Act of 2010, and other local anti-corruption laws that apply to our international activities;
- the federal Physician Payment Sunshine Act, or Open Payments, created under the Affordable Care Act, and its implementing regulations, which requires manufacturers of drugs, medical devices, biologicals and medical supplies for which payment is available under Medicare, Medicaid, or the Children's Health Insurance Program to report annually to the U.S. Department of Health and Human Services, or HHS, information related to payments or other transfers of value made to licensed physicians and teaching hospitals, as well as ownership and investment interests held by physicians and their immediate family members;
- HIPAA, as amended by the Health Information Technology for Economic and Clinical Health Act, and its implementing regulations, which impose certain requirements relating to the privacy, security and transmission of individually identifiable health information; HIPAA also created criminal liability for knowingly and willfully falsifying or concealing a material fact or making a materially false statement in connection with the delivery of or payment for healthcare benefits, items or services;
- the federal physician self-referral prohibition, commonly known as the Stark Law; and
- state law equivalents of each of the above federal laws, such as anti-kickback and false claims laws which may apply to items or services reimbursed by any third party payor, including commercial insurers, and state and foreign laws governing the privacy and security of health information in certain circumstances, many of which differ from each other in significant ways and often are not preempted by HIPAA, thus complicating compliance efforts.

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act, or Affordable Care Act, was enacted in 2010. The Affordable Care Act, among other things, amends the intent requirement of the federal Anti-Kickback Statute and criminal healthcare fraud statutes. A person or entity no longer needs to have actual knowledge of this statute or specific intent to violate it. In addition, the Affordable Care Act provides that the government may assert that a claim including items or services resulting from a violation of the federal Anti-Kickback Statute constitutes a false or fraudulent claim for purposes of the False Claims Act.

Because of the breadth of these laws and the narrowness of available statutory and regulatory exemptions, it is possible that some of our activities could be subject to challenge under one or more of such laws. Any action brought against us for violations of these laws or regulations, even successfully defended, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business. We may be subject to private "qui tam" actions brought by individual whistleblowers on behalf of the federal or state governments, with potential liability under the federal False Claims Act including mandatory treble damages and significant per-claim penalties.

The growth of our business and sales organization and our expansion outside of the United States may increase the potential of violating these laws. The risk of our being found in violation of these or other laws and regulations is further increased by the fact that many have not been fully interpreted by the regulatory authorities or the courts, and their provisions are open to a variety of interpretations. Any action brought against us for violation of these or other laws or regulations, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business. If our operations are found to be in violation of any of the federal, state and foreign laws described above or any other current or future fraud and abuse or other healthcare laws and regulations that apply to us, we may be subject to penalties, including significant criminal, civil, and administrative penalties, damages, fines, imprisonment, for individuals, exclusion from participation in government programs, such

as Medicare and Medicaid, and we could be required to curtail or cease certain of our operations. Any of the foregoing consequences could seriously harm our business and our financial results.

If we fail to maintain proper and effective internal controls, our ability to produce accurate financial statements on a timely basis could be impaired, which would adversely affect our business and our stock price.

Ensuring that we have adequate internal financial and accounting controls and procedures in place to produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be evaluated frequently. We may in the future discover areas of our internal financial and accounting controls and procedures that need improvement. Operating as a public company requires sufficient resources within the accounting and finance functions in order to produce timely financial information, ensure the level of segregation of duties, and maintain adequate internal control over financial reporting customary for a U.S. public company.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. Our management does not expect that our internal control over financial reporting will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within our company will have been detected.

Pursuant to Section 404 of the Sarbanes-Oxley Act, we perform periodic evaluations of our internal control over financial reporting. While we have in the past performed this evaluation and concluded that our internal control over financial reporting was operating effectively, there can be no assurance that in the future material weaknesses or significant deficiencies will not exist or otherwise be discovered. In addition, if we are unable to produce accurate financial statements on a timely basis, investors could lose confidence in the reliability of our financial statements, which could cause the market price of our common stock to decline and make it more difficult for us to finance our operations and growth.

Our ability to use net operating losses to offset future taxable income may be subject to substantial limitations.

Under Section 382 of the Internal Revenue Code, a corporation that undergoes an "ownership change" is subject to limitations on its ability to utilize its pre-change net operating losses ("NOLs") to offset future taxable income. We believe that we have had one or more ownership changes, as a result of which our existing NOLs are currently subject to limitation. Future changes in our stock ownership could result in additional ownership changes under Section 382. We may not be able to utilize a material portion of our NOLs even if we attain profitability.

Our sales cycle is unpredictable and lengthy, which makes it difficult to forecast revenue and may increase the magnitude of quarterly or annual fluctuations in our operating results.

The sales cycle for our sequencing instruments is lengthy because they represent a major capital expenditure and generally require the approval of our customers' senior management. This may contribute to substantial fluctuations in our quarterly or annual operating results, particularly during the periods in which our sales volume is low. Factors that may cause fluctuations in our quarterly or operating results include, without limitation, market acceptance for our products; our ability to attract new customers; publications of studies by us, competitors or third parties; the timing and success of new product introductions by us or our competitors or other changes in the competitive dynamics of our industry, such as consolidation; the amount and timing of our costs and expenses; changes in our pricing policies or those of our competitors; general economic, industry and market conditions; the regulatory environment; expenses

associated with warranty costs or unforeseen product quality issues; the hiring, training and retention of key employees, including our ability to grow our sales organization; litigation or other claims against us for intellectual property infringement or otherwise; our ability to obtain additional financing as necessary; and changes or trends in new technologies and industry standards. Because of these fluctuations, it is likely that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If that happens, the market price of our stock would likely decrease. Past fluctuations in our quarterly and annual operating results have resulted in decreases in our stock price. Such fluctuations also mean that investors may not be able to rely on our operating results in any particular period as an indication of future performance. Sales to existing customers and the establishment of a business relationship with other potential customers is a lengthy process, generally taking several months and sometimes longer. Following the establishment of the relationship, the negotiation of purchase terms can be time-consuming, and a potential customer may require an extended evaluation and testing period. In anticipation of product orders, we may incur substantial costs before the sales cycle is complete and before we receive any customer payments. As a result, in the event that a sale is not completed or is canceled or delayed, we may have incurred substantial expenses, making it more difficult for us to become profitable or otherwise negatively impacting our financial results. Furthermore, because of our lengthy sales cycle, the realization of revenue from our selling efforts may be substantially delayed, our ability to forecast our future revenue may be more limited and our revenue may fluctuate significantly from quarter to quarter.

Our operations involve the use of hazardous materials, and we must comply with environmental, health and safety laws, which can be expensive and may adversely affect our business, operating results and financial condition.

Our research and development and manufacturing activities involve the use of hazardous materials, including chemicals and biological materials, and some of our products include hazardous materials. Accordingly, we are subject to federal, state, local and foreign laws, regulations and permits relating to environmental, health and safety matters, including, among others, those governing the use, storage, handling, exposure to and disposal of hazardous materials and wastes, the health and safety of our employees, and the shipment, labeling, collection, recycling, treatment and disposal of products containing hazardous materials. Liability under environmental laws and regulations can be joint and several and without regard to fault or negligence. For example, under certain circumstances and under certain environmental laws, we could be held liable for costs relating to contamination at our or our predecessors' past or present facilities and at third-party waste disposal sites. We could also be held liable for damages arising out of human exposure to hazardous materials. There can be no assurance that violations of environmental, health and safety laws will not occur as a result of human error, accident, equipment failure or other causes. The failure to comply with past, present or future laws could result in the imposition of substantial fines and penalties, remediation costs, property damage and personal injury claims, investigations, the suspension of production or product sales, loss of permits or a cessation of operations. Any of these events could harm our business, operating results and financial condition. We also expect that our operations will be affected by new environmental, health and safety laws and regulations on an ongoing basis, or more stringent enforcement of existing laws and regulations. New laws or changes to existing laws may result in additional costs and may increase penalties associated with violations or require us to change the content of our products or how we manufacture them, which could have a material adverse effect on our business, operating results and financial condition.

Our facilities in California are located near earthquake faults, and the occurrence of an earthquake or other catastrophic disaster could cause damage to our facilities and equipment, which could require us to cease or curtail operations.

Our facilities in the San Francisco Bay Area are located near earthquake fault zones and are vulnerable to damage from earthquakes. We are also vulnerable to damage from other types of disasters, including fire, floods, power loss, communications failures and similar events. If any disaster were to occur, our ability to operate our business at our facilities would be seriously, or potentially completely, impaired. In addition, the nature of our activities could cause significant delays in our research programs and commercial activities and make it difficult for us to recover from a disaster. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Accordingly, an earthquake or other disaster could materially and adversely harm our ability to conduct business.

Our ability to successfully manage our transition to our new headquarters could result in a material adverse effect on our business or operations if we underestimate the costs of the transition, experience delays or quality issues with our manufacturing, or if internal measures to mitigate these risks are not effective.

We are in the process of transitioning to our new headquarters in Menlo Park, California. The transition may involve unanticipated delays, which could materially impact our desired commercial timelines and there is no assurance that we will be able to move into our new headquarters without any material interruption to our business. The successful transition of our headquarters, including the transition of our manufacturing facilities, is largely dependent upon the cooperation and continued performance of both our current and future landlords, as well as third-party contractors who are preparing certain shell improvements and tenant improvements. During the transition period, we must successfully establish and implement procedures to ensure that our current and future manufacturing facilities meet our quality standards while maintaining a reasonable cost structure. In addition, after our new manufacturing facilities have been qualified, it may take a considerable period of time to commence volume production. We have already

devoted significant expenses and resources in connection with the transition, and there is no assurance that we can manage the transition successfully.

In addition, the transition to our new headquarters may delay or disrupt our ability to perform critical functions, distract our management and employees or result in unanticipated expenses, all of which could negatively affect our business, at least in the near term. There may also be additional costs associated with running separate manufacturing facilities until our in-house manufacturing has been relocated to the new headquarters, and such costs may exceed our projections. If the transition does not go as expected, in addition to other issues noted above, we could experience delayed shipments of products, unexpected cost overruns or quality issues, or loss of our ISO certifications, each of which could have a material adverse effect on our business, operating results and business reputation. Moreover, in the event that we breach any of our current Menlo Park facility real property leases and fail to cure such breach within the time permitted, the landlord would have no obligation to make the final payment due to us under the leases, as amended, as consideration for our agreement to amend the leases.

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Ethical, legal, privacy and social concerns or governmental restrictions surrounding the use of genetic information could reduce demand for our technology.

Our products may be used to provide genetic information about humans, agricultural crops and other living organisms. The information obtained from our products could be used in a variety of applications which may have underlying ethical, legal, privacy and social concerns, including the genetic engineering or modification of agricultural products or testing for genetic predisposition for certain medical conditions. Governmental authorities could, for safety, social or other purposes, call for limits on or regulation of the use of genetic testing. Such concerns or governmental restrictions could limit the use of our products, which could have a material adverse effect on our business, financial condition and results of operations.

Disruption of critical information technology systems or material breaches in the security of our systems could harm our business, customer relations and financial condition.

Information technology (“IT”) helps us to operate efficiently, interface with customers, maintain financial accuracy and efficiently and accurately produce our financial statements. IT systems are used extensively in virtually all aspects of our business, including sales forecast, order fulfillment and billing, customer service, logistics, and management of data from running samples on our products. Our success depends, in part, on the continued and uninterrupted performance of our IT systems. IT systems may be vulnerable to damage from a variety of sources, including telecommunications or network failures, power loss, natural disasters, human acts, computer viruses, computer denial-of-service attacks, unauthorized access to customer or employee data or company trade secrets, and other attempts to harm our systems. Certain of our systems are not redundant, and our disaster recovery planning is not sufficient for every eventuality. Despite any precautions we may take, such problems could result in, among other consequences, disruption of our operations, which could harm our reputation and financial results.

If we do not allocate and effectively manage the resources necessary to build and sustain the proper IT infrastructure, we could be subject to transaction errors, processing inefficiencies, loss of customers, business disruptions or loss of or damage to intellectual property through security breach. If our data management systems do not effectively collect, store, process and report relevant data for the operation of our business, whether due to equipment malfunction or constraints, software deficiencies or human error, our ability to effectively plan, forecast and execute our business plan and comply with applicable laws and regulations will be impaired, perhaps materially. Any such impairment could materially and adversely affect our reputation, financial condition, results of operations, cash flows and the timeliness with which we report our internal and external operating results.

Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.

In the ordinary course of our business, we collect and store sensitive data, including intellectual property, our proprietary business information and that of our customers, suppliers and business partners, and personally identifiable information of our customers and employees, in our data centers and on our networks. The secure processing, maintenance and transmission of this information is critical to our operations. Despite our security measures, our IT infrastructure may be vulnerable to attacks by hackers, computer viruses, malicious codes, unauthorized access attempts, and cyber- or phishing-attacks, or breached due to employee error, malfeasance, faulty password management or other disruptions. Third parties may attempt to fraudulently induce employees or other persons into disclosing user names, passwords or other sensitive information, which may in turn be used to access our IT systems, commit identity theft or carry out other unauthorized or illegal activities. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, disruption of our operations and damage to our reputation, which

could divert our management's attention from the operation of our business and materially and adversely affect our business, revenues and competitive position. Moreover, we may need to increase our efforts to train our personnel to detect and defend against cyber- or phishing-attacks, which are becoming more sophisticated and frequent, and we may need to implement additional protective measures to reduce the risk of potential security breaches, which could cause us to incur significant additional expenses.

Regulations related to conflict minerals has caused us to incur, and will continue to cause us to incur, additional expenses and could limit the supply and increase the costs of certain materials used in the manufacture of our products.

We are subject to requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that require us to conduct diligence, and report whether or not our products contain conflict minerals. The implementation of these requirements could adversely affect the sourcing, availability and pricing of the materials used in the manufacture of components used in our products. Furthermore, the complex nature of our products requires components and materials that may be available only from a limited number of sources and, in some cases, from only a single source. We have incurred, and will continue to incur, additional costs to comply with the disclosure requirements, including costs related to conducting diligence procedures to determine the sources of conflict minerals that may be used or necessary to the production of our products and, if applicable, potential changes to components, processes or sources of supply as a consequence of such verification activities. We may face reputational harm if we determine that certain of our products

contain minerals that are not determined to be conflict free or if we are unable to alter our processes or sources of supply to avoid using such materials. Reputational harm could materially and adversely affect our business, financial condition or results of operations.

Risks Related to Our Intellectual Property

Failure to secure patent or other intellectual property protection for our products and improvements to our products may reduce our ability to maintain any technological or competitive advantage over our current and potential competitors.

Our ability to protect and enforce our intellectual property rights is uncertain and depends on complex legal and factual questions. Our ability to establish or maintain a technological or competitive advantage over our competitors may be diminished because of these uncertainties. For example:

- we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications or issued patents;
- we or our licensors might not have been the first to file patent applications for these inventions;
- it is possible that neither our pending patent applications nor the pending patent applications of our licensors will result in issued patents;
- the scope of the patent protection we or our licensors obtain may not be sufficiently broad to prevent others from practicing our technologies, developing competing products, designing around our patented technologies or independently developing similar or alternative technologies;
- our and our licensors' patent applications or patents have been, are and may in the future be, subject to interference, opposition or similar administrative proceedings, which could result in those patent applications failing to issue as patents, those patents being held invalid or the scope of those patents being substantially reduced;
- we or our partners may not adequately protect our trade secrets;
- we may not develop additional proprietary technologies that are patentable; or
- the patents of others may limit our freedom to operate and prevent us from commercializing our technology in accordance with our plans.

The occurrence of any of these events could impair our ability to operate without infringing upon the proprietary rights of others or prevent us from establishing or maintaining a competitive advantage over our competitors.

Variability in intellectual property laws may adversely affect our intellectual property position.

Intellectual property laws, and patent laws and regulations in particular, have been subject to significant variability either through administrative or legislative changes to such laws or regulations or changes or differences in judicial interpretation, and it is expected that such variability will continue to occur. Additionally, intellectual property laws and regulations differ by country. Variations in the patent laws and regulations or in interpretations of patent laws and regulations in the United States and other countries may diminish the value of our intellectual property and may change the impact of third-party intellectual property on us. Accordingly, we cannot predict the scope of the patents that may be granted to us with certainty, the extent to which we will be able to enforce our patents against third parties or the extent to which third parties may be able to enforce their patents against us.

Some of the intellectual property that is important to our business is owned by other companies or institutions and licensed to us, and changes to the rights we have licensed may adversely impact our business.

We license from third parties some of the intellectual property that is important to our business. If we fail to meet our obligations under these licenses, these third parties could terminate the licenses. If the third parties who license intellectual property to us fail to maintain the intellectual property that we have licensed, or lose rights to that

intellectual property, the rights we have licensed may be reduced or eliminated, which could subject us to claims of intellectual property infringement. Termination of these licenses or reduction or elimination of our licensed rights may result in our having to negotiate new or reinstated licenses with less favorable terms, or could subject us to claims of intellectual property infringement in litigation or other administrative proceedings that could result in damage awards against us and injunctions that could prohibit us from selling our products. In addition, some of our licenses from third parties limit the field in which we can use the licensed technology. Therefore, in order for us to use such licensed technology in potential future applications that are outside the licensed field of use, we may be required to negotiate new licenses with our licensors or expand our rights under our existing licenses. We cannot assure you that we will be able to obtain such licenses or expanded rights on reasonable terms or at all. In addition, we have limited rights to participate in the prosecution and enforcement of the patents and patent applications that we have licensed. As a result, we cannot be certain that these patents and applications will be prosecuted and enforced in a manner consistent with the best interests of our business. Further, because of the rapid pace of technological change in our industry, we may need to rely on key technologies developed or licensed by third parties, and we may not be able to obtain licenses and technologies from these third parties at all or on reasonable terms. The occurrence of these events may have a material adverse effect on our business, financial condition or results of operations.

The measures that we use to protect the security of our intellectual property and other proprietary rights may not be adequate, which could result in the loss of legal protection for, and thereby diminish the value of, such intellectual property and other rights.

In addition to patents, we also rely upon trademarks, trade secrets, copyrights and unfair competition laws, as well as license agreements and other contractual provisions, to protect our intellectual property and other proprietary rights. Despite these measures, any of our intellectual property rights could be challenged, invalidated, circumvented or misappropriated. In addition, we attempt to protect our intellectual property and proprietary information by requiring our employees and consultants to enter into confidentiality and assignment of inventions agreements, and by entering into confidentiality agreements with our third-party development, manufacturing, sales and distribution partners, who may also acquire, develop and/or commercialize alternative or competing products or provide services to our competitors. For example, Roche has had certain access to our trade secrets and other proprietary information pursuant to the Roche Agreement, subject to the confidentiality provisions thereof (certain of which provisions survive the termination of the Roche Agreement); however, Roche is developing potentially competing sequencing products through its acquisition of Genia Technologies. There can be no assurance that our measures will provide adequate protection for our intellectual property and proprietary information. These agreements may be breached, and we may not have adequate remedies for any such breach. In addition, our trade secrets and other proprietary information may be disclosed to others, or others may gain access to or disclose our trade secrets and other proprietary information. Enforcing a claim that a third party illegally obtained and is using our trade secrets is expensive and time consuming, and the outcome is unpredictable. Additionally, others may independently develop proprietary information and techniques that are substantially equivalent to ours. The occurrence of these events may have a material adverse effect on our business, financial condition or results of operations.

Our intellectual property may be subject to challenges in the United States or foreign jurisdictions that could adversely affect our intellectual property position.

Our pending, issued and granted U.S. and foreign patents and patent applications have been, are and may in the future be, subject to challenges by third parties asserting prior invention by others or invalidity on various grounds, through proceedings, such as interferences, reexamination or opposition proceedings. Addressing these challenges to our intellectual property has been, and any future challenges can be, costly and distract management's attention and resources. For example, we previously incurred significant legal expenses to litigate and settle a complaint seeking review of a patent interference decision of the U.S. Patent and Trademark Office. Additionally, as a result of these challenges, our patents or pending patent applications may be determined to be unpatentable to us, invalidated or unenforceable in whole or in part. Accordingly, adverse rulings in these proceedings may negatively impact the scope of our intellectual property protection for our products and technology, and may materially and adversely affect our business.

Some of our technology is subject to "march-in" rights by the U.S. government.

Some of our patented technology was developed with U.S. federal government funding. When new technologies are developed with U.S. government funding, the government obtains certain rights in any resulting patents, including a nonexclusive license authorizing the government to use the invention for non-commercial purposes. These rights may permit the government to disclose our confidential information to third parties and to exercise "march-in" rights to use or allow third parties to use our patented technology. The government can exercise its march-in rights if it determines that such action is necessary to (i) achieve practical application of the U.S. government-funded technology, (ii) alleviate health or safety needs, (iii) meet requirements of federal regulations, or (iv) give preference to U.S. industry. In addition, U.S. government-funded inventions must be reported to the government and such government funding must be disclosed in any resulting patent applications. Furthermore, our rights in such inventions are subject to government license rights and foreign manufacturing restrictions.

We are involved in legal proceedings to enforce our intellectual property rights.

Our intellectual property rights involve complex factual, scientific and legal questions. We operate in an industry characterized by significant intellectual property litigation. Even though we may believe that we have a valid patent on a particular technology, other companies may have from time to time taken, and may in the future take, actions that we believe violate our patent rights. For example, we have filed a complaint with the USITC against ONT for patent infringement. Legal actions to enforce our patent rights can be expensive and may involve the diversion of significant management time and resources and adverse parties may bring claims against us and/or our intellectual property. Our enforcement actions may not be successful, could give rise to legal claims against us and could result in some of our intellectual property rights being determined to be invalid or not enforceable.

We could in the future be subject to legal proceedings with third parties who may claim that our products infringe or misappropriate their intellectual property rights.

Our products are based on complex, rapidly developing technologies. We may not be aware of issued or previously filed patent applications that belong to third parties that mature into issued patents that cover some aspect of our products or their use. In addition, because patent litigation is complex and the outcome inherently uncertain, our belief that our products do not infringe third-party patents of which we are aware or that such third-party patents are invalid and unenforceable may be determined to be incorrect. As a result, third

parties have claimed, and may in the future claim, that we infringe their patent rights and have filed, and may in the future file, lawsuits or engage in other proceedings against us to enforce their patent rights. In addition, as we enter new markets, our competitors and other third parties may claim that our products infringe their intellectual property rights as part of a business strategy to impede our successful entry into those markets. Furthermore, parties making claims against us may be able to obtain injunctive or other relief, which effectively could block our ability to develop further, commercialize, or sell products or services, and could result in the award of substantial damages against us. Patent litigation between competitors in our industry is common. Additionally, we have certain obligations to many of our customers and suppliers to indemnify and defend them against claims by third parties that our products or their use infringe any intellectual property of these third parties. In defending ourselves against any of these claims, we have in the past incurred, and could in the future incur, substantial costs, and the attention of our management and technical personnel could be diverted. For example, we previously incurred significant legal expenses to litigate and settle a complaint alleging patent infringement. Even if we have an agreement that indemnifies us against such costs, the indemnifying party may be unable to uphold its contractual obligations. To avoid or settle legal claims, it may be necessary or desirable in the future to obtain licenses relating to one or more products or relating to current or future technologies, which could negatively affect our gross margins. We may not be able to obtain these licenses on commercially reasonable terms, or at all. We may be unable to modify our products so that they do not infringe the intellectual property rights of third parties. In some situations, the results of litigation or settlement of claims may require us to cease allegedly infringing activities which could prevent us from selling some or all of our products. The occurrence of these events may have a material adverse effect on our business, financial condition or results of operations.

In addition, in the course of our business, we may from time to time have access or be alleged to have access to confidential or proprietary information of others, which, though not patented, may be protected as trade secrets. Others could bring claims against us asserting that we improperly used their confidential or proprietary information, or that we misappropriated their technologies and incorporated those technologies into our products. A determination that we illegally used the confidential or proprietary information or misappropriated technologies of others in our products could result in us paying substantial damage awards or being prevented from selling some or all of our products, which could materially and adversely affect our business.

We have not yet registered some of our trademarks in all of our potential markets, and failure to secure those registrations could adversely affect our business.

Some of our trademark applications may not be allowed for registration, and our registered trademarks may not be maintained or enforced. In addition, in the U.S. Patent and Trademark Office and in comparable agencies in many foreign jurisdictions, third parties are given an opportunity to oppose pending trademark applications and to seek to cancel registered trademarks. Opposition or cancellation proceedings may be filed against our trademarks, and our trademarks may not survive such proceedings.

Our use of “open source” software could adversely affect our ability to sell our products and subject us to possible litigation.

A portion of our products or technologies developed and/or distributed by us incorporate “open source” software, and we may incorporate open source software into other products or technologies in the future. Some open source software licenses require that we disclose the source code for any modifications to such open source software that we make and distribute to one or more third parties, and that we license the source code for such modifications to third parties, including our competitors, at no cost. We monitor the use of open source software in our products to avoid uses in a manner that would require us to disclose or grant licenses under our source code that we wish to maintain as proprietary; however, there can be no assurance that such efforts have been or will be successful. In some circumstances, distribution of our software that includes or is linked with open source software could require that we

disclose and license some or all of our proprietary source code in that software, which could include permitting the use of such software and source code at no cost to the user. Open source license terms are often ambiguous and there is little legal precedent governing the interpretation of these licenses. Successful claims made by the licensors of open source software that we have violated the terms of these licenses could result in unanticipated obligations, including being subject to significant damages, being enjoined from distributing products that incorporate open source software and being required to make available our proprietary source code pursuant to an open source license, which could substantially help our competitors develop products that are similar to or better than ours or otherwise materially and adversely affect our business.

Risks Related to Owning Our Common Stock

The price of our common stock has been, is, and may continue to be, highly volatile, and you may be unable to sell your shares at or above the price you paid to acquire them.

The market price of our common stock is highly volatile, and we expect it to continue to be volatile for the foreseeable future in response to many risk factors listed in this section, and others beyond our control, including:

- actual or anticipated fluctuations in our financial condition and operating results;
- announcements of technological innovations by us or our competitors;

- announcements by our customers, partners or suppliers relating directly or indirectly to our products, services or technologies;
- overall conditions in our industry and market;
- addition or loss of significant customers;
- changes in laws or regulations applicable to our products;
- actual or anticipated changes in our growth rate relative to our competitors;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures, capital commitments or achievement of significant milestones;
- additions or departures of key personnel;
- competition from existing products or new products that may emerge;
- issuance of new or updated research or reports by securities analysts;
- fluctuations in the valuation of companies perceived by investors to be comparable to us;
- disputes or other developments related to proprietary rights, including patents, litigation matters or our ability to obtain intellectual property protection for our technologies;
- announcement or expectation of additional financing efforts;
- sales of our common stock by us or our stockholders;
- stock price and volume fluctuations attributable to inconsistent trading volume levels of our shares;
- reports, guidance and ratings issued by securities or industry analysts; and
- general economic and market conditions.

If any of the forgoing occurs, it would cause our stock price or trading volume to decline. Stock markets in general and the market for companies in our industry in particular have experienced price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions such as recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our common stock. You may not realize any return on your investment in us and may lose some or all of your investment. In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We have been a party to this type of litigation in the past and may be the target of this type of litigation again in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Future sales of our common stock could cause our stock price to fall.

We maintain a shelf registration statement on Form S-3 with the SEC pursuant to which we may, from time to time, sell up to an aggregate of \$150 million of our common stock, preferred stock, depositary shares, warrants, units or debt securities. We have established, and may in the future establish, "at-the-market" offering programs pursuant to which we may offer and sell shares of our common stock. In February 2017, we filed an additional prospectus supplement pursuant to which we may offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$60.0 million under an "at-the-market" offering program. Sales of securities under the registration statement have resulted and will continue to result in dilution of our existing stockholders, and such sales could cause our stock price to fall.

In addition, if our existing stockholders sell, or indicate an intent to sell, a large number of shares of our common stock in the public market, it could cause our stock price to fall. We may also issue shares of common stock or securities convertible into our common stock from time to time in connection with financings, acquisitions, investments or otherwise. Any such issuance would result in dilution to our existing stockholders and could cause our stock price to fall.

Concentration of ownership by our principal stockholders may result in control by such stockholders of the composition of our board of directors.

Our existing significant stockholders, executive officers, directors and their affiliates beneficially own a significant number of our outstanding shares of common stock. As a result, these stockholders will be able to exercise a significant level of control over all matters requiring stockholder approval, including the election of directors. This control could have the effect of delaying or preventing a change of control of our company or changes in management and will make the approval of certain transactions difficult or impossible without the support of these stockholders.

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Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management and limit the market price of our common stock.

Provisions in our certificate of incorporation and bylaws, as amended and restated, may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and bylaws include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 50,000,000 shares of undesignated preferred stock and up to approximately 1,000,000,000 shares of authorized but unissued shares of common stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our board of directors, the Chairman of the Board, the Chief Executive Officer or the President;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause; and
- provide that vacancies on our board of directors may be filled only by a majority of directors then in office, even though less than a quorum.

These provisions may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which limits the ability of stockholders owning in excess of 15% of our outstanding voting stock to merge or combine with us.

Our large number of authorized but unissued shares of common stock may potentially dilute existing stockholders' stockholdings.

We have a significant number of authorized but unissued shares of common stock. Our board of directors may issue shares of common stock from this authorized but unissued pool from time to time without stockholder approval, resulting in the dilution of our existing stockholders.

We do not intend to pay dividends for the foreseeable future.

We have never declared or paid any dividends on our common stock and do not intend to pay any dividends in the foreseeable future. In addition, the terms of our existing debt agreement restrict our ability to pay dividends on our common stock. We anticipate that we will retain all of our future earnings for use in the operation of our business and for general corporate purposes. Any determination to pay dividends in the future will be at the discretion of our board of directors. Accordingly, investors must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investments.

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ITEM 1B.UNRESOLVED STAFF COMMENTS

None.

ITEM 2.PROPERTIES

As of December 31, 2015, we leased approximately 186,000 square feet in Menlo Park, California, where we housed our headquarters, research and development, service and support functions, and our in-house manufacturing operations. In July 2015 we amended the terms and conditions of our existing leases for the Menlo Park facility to, among other things, extend the terms of most of the leases to expire on September 30, 2017. In June 2016 and January 2017 we further amended the terms and conditions of our existing leases for the Menlo Park facility to, among other things, modify the payment schedule and increase the amount of the payments receivable from our existing landlord. As of December 31, 2016, we leased approximately 172,000 square feet under the amended Menlo Park facility real property leases. We also lease a sales office facility in Singapore, and engineering support facilities in San Francisco, California

In addition, in July 2015 we entered into a new lease agreement (the "O'Brien Lease") with respect to our premises at 1305 O'Brien Drive, Menlo Park, California (the "O'Brien Premises"). The term of the O'Brien Lease is one hundred thirty-two (132) months, commencing on the date that is the later of April 15, 2016 or the date on which the O'Brien Premises landlord has substantially completed certain shell improvements and tenant improvements. In December 2016, we entered into an amendment to the O'Brien Lease which defined the commencement date of the lease to be October 25, 2016, notwithstanding that such substantial completion date had not yet occurred. We did not have control of the building until after December 31, 2016. As of January 1, 2017, we lease approximately 180,000 square feet under the amended O'Brien Lease.

We believe that our existing facilities, together with suitable additional or alternative space available on commercially reasonable terms, will be sufficient to meet our needs.

ITEM 3.LEGAL PROCEEDINGS

On November 2, 2016, we filed a complaint against Oxford Nanopore Technologies Ltd., Oxford Nanopore Technologies, Inc. and Metrichor, Ltd. (together, "ONT") with the U.S. International Trade Commission ("USITC") for patent infringement. On December 5, 2016, the USITC provided notice that an investigation had been instituted based on the complaint. We are seeking exclusionary relief with respect to several ONT products, including ONT's MinION and PromethION devices. The complaint is based on our U.S. Patent No. 9,404,146, entitled "Compositions and methods for nucleic acid sequencing" which covers novel methods for sequencing single nucleic acid molecules using linked double-stranded nucleic acid templates, providing improved sequencing accuracy. On March 1, 2017, we filed an amended complaint to add a second patent in the same patent family, U.S. Patent No. 9,542,527, which was granted on January 10, 2017, to the investigation. We are seeking, among other things, an exclusion order permanently barring entry of infringing ONT products into the United States, and a cease and desist order preventing ONT from advertising and selling infringing products in the United States.

On February 2, 2017, we filed a claim in the High Court of England and Wales against Oxford Nanopore Technologies Ltd. and Metrichor, Ltd. for infringement of Patent EP(UK) 3 025 542, which is in the same patent family as the patents asserted in the USITC action referred to above. We are seeking remedies including injunctive relief, damages, and costs.

From time to time, we may also be involved in a variety of other claims, lawsuits, investigations and proceedings relating to securities laws, product liability, patent infringement, contract disputes, employment and other matters that arise in the normal course of our business. In addition, third parties may, from time to time, assert claims against us in the form of letters and other communications. We record a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We currently do not believe that the ultimate outcome of any of the matters described above is probable or reasonably estimable, or that these matters will have a material adverse effect on our business; however, the results of litigation and claims are inherently unpredictable. Regardless of the outcome, litigation can have an adverse impact on us because of litigation and settlement costs, diversion of management resources and other factors.

ITEM 4.MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on The Nasdaq Global Select Market under the symbol “PACB.” The following table sets forth the high and low sales prices per share for our common stock for the indicated fiscal periods:

	2016		2015	
	High	Low	High	Low
4th Quarter	\$ 9.28	\$ 3.76	\$ 14.00	\$ 4.26
3rd Quarter	9.50	6.76	5.90	3.58
2nd Quarter	10.75	6.79	6.55	5.11
1st Quarter	13.98	7.50	8.78	5.38

Holders of Record

As of February 28, 2017, there were approximately 43 stockholders of record of our common stock, although we believe that there are a significantly larger number of beneficial owners of our common stock.

Dividend Policy

We have never declared or paid any cash dividend on our common stock and have no present plans to do so. We intend to retain earnings for use in the operation and expansion of our business. In addition, our ability to pay dividends is limited pursuant to covenants in our debt agreements.

Securities Authorized for Issuance under Equity Compensation Plans

The following table contains information as of December 31, 2016 for our equity compensation plans.

Number of securities to be issued upon exercise	Weighted-average exercise price of	Number of securities remaining available for future issuance under compensation plans
-------------------------------------------------	------------------------------------	---------------------------------------------------------------------------------------

Plan category	of outstanding options, warrants and rights (a)	outstanding options, warrants and rights	(excluding securities reflected in column(a))
Equity compensation plans approved by security holders	22,501,270	\$ 6.30	6,524,789
Equity compensation plans not approved by security holders	—	—	—

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Performance Graph

The performance graph included in this Annual Report on Form 10-K shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or incorporated by reference into any filing of Pacific Biosciences under the Securities Act of 1933, as amended, or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

The following graph shows a comparison from December 31, 2011 through December 31, 2016 of the cumulative total return for our common stock, the Nasdaq Composite Index and the Nasdaq Biotechnology Index. Such returns are based on historical results and are not intended to suggest future performance. Data for The Nasdaq Composite Index and the Nasdaq Biotechnology Index assume reinvestment of dividends.

	12/2011	12/2012	12/2013	12/2014	12/2015	12/2016
Pacific Biosciences of California, Inc.	\$ 100.00	\$ 60.71	\$ 186.79	\$ 280.00	\$ 468.93	\$ 135.71
NASDAQ Composite Index	100.00	116.41	165.47	188.69	200.32	216.54
NASDAQ Biotechnology Index	100.00	134.68	232.37	307.67	328.76	262.08

Recent Sales of Unregistered Securities

None.

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Use of Proceeds

During April 2012, we filed a shelf registration statement on Form S-3 with the SEC pursuant to which we could, from time to time, sell up to an aggregate of \$150.0 million of our common stock, preferred stock, depository shares, warrants, units or debt securities. On May 1, 2012, the registration statement was declared effective by the SEC, which allowed us to access the capital markets for three years following the effective date.

On October 5, 2012, we entered into a sales agreement pursuant to which we sold shares of our common stock having an aggregate offering price of approximately \$30.0 million through an “at-the-market” offering.

On November 8, 2013, we amended the sales agreement to increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

In November 2014, we filed a shelf registration statement on Form S-3 with the SEC pursuant to which we may, from time to time, sell up to an aggregate of \$150.0 million of our common stock, preferred stock, depository shares, warrants, units or debt securities. On November 21, 2014, the registration statement was declared effective by the SEC, which would allow us to access the capital markets for three years following the effective date.

On February 3, 2015, we amended the sales agreement again in order to further increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On February 3, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Such aggregate offering price of shares of our common stock was in addition to the shares sold under the original sales agreement, dated October 5, 2012, the first amendment to the sales agreement, dated November 8, 2013, and the second amendment to the sales agreement, dated February 3, 2015. Pursuant to the prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On May 18, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Pursuant to such prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

We pay a commission equal to 3% of the gross proceeds from the sale of shares of our common stock under the sales agreement. We are not obligated to sell shares of our common stock under the sales agreement.

As of December 31, 2016, we have sold a total of 24.7 million shares of our common stock at an average price of \$6.08 through our “at-the-market” offering, for total net proceeds of \$145.5 million.

On February 2, 2017, we filed an additional prospectus supplement pursuant to which we may offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$60.0 million under the sales agreement.

We may need to raise additional capital in the future through the sale of equity or convertible debt securities, including future “at-the-market” offerings.

ITEM 6. SELECTED FINANCIAL DATA

Our historical results are not necessarily indicative of the results to be expected for any future period. The following selected financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K.

	Year Ended December 31,				
	2016	2015	2014	2013	2012
	(in thousands except per share amounts)				
Total revenue (1)(2)	\$ 90,714	\$ 92,782	\$ 60,594	\$ 28,181	\$ 25,983
Total cost of revenue (1)	46,554	39,332	37,192	21,762	25,043
Gross profit (1)	44,160	53,450	23,402	6,419	940
Gain on lease amendments (3)	—	(23,043)	—	—	—
Total operating expense	115,404	82,584	86,256	83,962	95,278
Operating loss	(71,244)	(29,134)	(62,854)	(77,543)	(94,338)
Net loss	\$ (74,375)	\$ (31,696)	\$ (66,160)	\$ (79,293)	\$ (94,465)
Net loss per share:					
Basic and diluted net loss per share	\$ (0.83)	\$ (0.42)	\$ (0.94)	\$ (1.26)	\$ (1.69)

Shares used in computing basic and diluted net loss per share (4)

89,148 75,614 70,475 62,784 55,733

As of December 31,

2016 2015 2014 2013 2012

(in thousands)

Cash, cash equivalents and investments	\$ 71,978	\$ 82,270	\$ 101,348	\$ 112,528	\$ 100,580
Working capital	75,237	72,363	86,271	103,904	100,257
Total assets	137,884	131,107	124,390	136,036	129,683
Total liabilities (5)	53,216	57,567	69,441	66,856	20,301
Total stockholders' equity (4)	\$ 84,668	\$ 73,540	\$ 54,949	\$ 69,180	\$ 109,382

- (1) We began recording product and service revenue and the related cost of revenue in 2011 from sales of our instruments and consumables. Prior to 2011, our revenue and gross profit consisted solely of grant revenue. Prior to 2012, cost of revenue and gross profit do not reflect certain costs, as instrument components acquired prior to September 30, 2010 were expensed as period costs.
- (2) During 2013, we entered into the Roche Agreement and received a non-refundable up-front payment of \$35.0 million. Revenue for the year ended December 31, 2014 consists of four quarterly periods of amortization of \$1.7 million from the non-refundable up-front payment of \$35.0 million. Revenue for the year ended December 31, 2015 consists of four quarterly periods of amortization of \$3.6 million, reflecting the increased certainty of the development time period. Revenue for the year ended December 31, 2016 included amortization of \$3.6 million of the upfront Roche payment for each of the first three quarters of 2016, plus amortization of \$1.3 million for the fourth quarter of 2016 upon our receipt of notice on December 2016 that Roche had elected to terminate the Roche Agreement, which became effective on February 10, 2017. In addition, we achieved the first development milestone under the Roche Agreement and recorded the related \$10.0 million as contractual revenue during the year ended December 31, 2014. We achieved the second and third (final) development milestones under the Roche Agreement and recognized the related \$10.0 million and \$20.0 million, respectively, as contractual revenue during the year ended December 31, 2015. Please see "Note 3. Contractual Revenue" in Part II, Item 8 of this Form 10-K for additional information.
- (3) Comprised of one-time gain of \$23.0 million associated with the lease amendment agreements with our existing landlord, which amended the terms and conditions of certain of our existing Menlo Park facility real property leases. Please see "Note 7. Commitments and Contingencies" in Part II, Item 8 of this Form 10-K for additional information.
- (4) From 2012 to 2016, we established various "at-the-market" offerings pursuant to which we could offer and sell shares of our common stock. Our first sales through our "at-the-market" offering occurred in 2013 and as of December 31, 2016, we have sold a total of 24.7 million shares of our common stock at an average price of \$6.08, for total net proceeds of \$145.5 million. Please see "Note 9. Stockholders' Equity" in Part II, Item 8 of this Form 10-K for additional information.
- (5) During 2013, we entered into a debt agreement pursuant to which we received \$20.5 million in funding and issued promissory notes in the aggregate principal amount of \$20.5 million and warrants to purchase 5,500,000 shares of our common stock. Please see "Note 6. Notes Payable" in Part II, Item 8 of this Form 10-K for additional information.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations together with our consolidated financial statements and the related notes included in this Form 10-K. Some of the information contained in this discussion and analysis or set forth elsewhere in this Form 10-K, including information with respect to our plans and strategy for our business and related financing, includes forward-looking statements that involve risks and uncertainties. You should read the "Risk Factors" section of this Form 10-K for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

Overview

We design, develop and manufacture sequencing systems to help scientists resolve genetically complex problems. Based on our novel Single Molecule, Real-Time (SMRT®) sequencing technology, our products enable: de novo genome assembly to finish genomes in order to more fully identify, annotate and decipher genomic structures; full-length transcript analysis to improve annotations in reference genomes, characterize alternatively spliced isoforms in important gene families, and find novel genes; targeted sequencing to more comprehensively characterize genetic variations; and real-time kinetic information for epigenome characterization. Our technology provides high accuracy, ultra-long reads, uniform coverage, and is the only DNA sequencing technology that provides the ability to simultaneously detect epigenetic changes. PacBio® sequencing systems, including consumables and software, provide a simple, fast, end-to-end workflow for SMRT sequencing.

Business Events

Product Developments.

In September 2015, we announced a new nucleic acid sequencing platform, the Sequel System, which provides higher throughput, more scalability, a reduced footprint and lower sequencing project costs compared to the PacBio RS II System, while maintaining the existing benefits of our SMRT technology. The core of the Sequel System is the capacity of its redesigned SMRT Cells, which contain approximately one million zero-mode waveguides (ZMWs) at launch, compared to approximately 150,000 ZMWs in the PacBio RS II System. We began limited shipments of the Sequel System in the United States during the fourth quarter of 2015, scaled up our manufacturing process for the Sequel Systems and the new SMRT Cells during 2016 and intend to continue to develop and refine our manufacturing processes for increased volume in 2017.

Agreement with Roche

In September 2013, we entered into the Roche Agreement with Roche, pursuant to which we accounted for, and recognized as revenue, the up-front payment received thereunder using the proportional performance method over the periods in which the delivery of elements pursuant to the Roche Agreement occurs. We recognized revenue under the Roche Agreement using a straight-line convention over the service periods of the deliverables as this method approximated our performance of services pursuant to the Roche Agreement. Out of the \$35.0 million upfront cash payment received, quarterly amortization of \$1.7 million was recognized as contractual revenue from the fourth quarter of 2013 to the fourth quarter of 2014. Beginning in the three-month period ended March 31, 2015, we revised the estimated development period related to our contractual revenue amortization based on increasing certainty of the development time on a prospective approach and quarterly amortization of \$3.6 million was recognized as contractual revenue for each of the four quarters of 2015 and for each of the first three quarters of 2016. As of September 30, 2016, the total deferred contractual revenue balance was \$1.3 million, relating to the amount allocated to the

deliverable of our participation on the joint steering committee. In December 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience, and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. Upon such notice, no further participation on the joint steering committee was deemed necessary; as such, we recognized the entire remaining unamortized deferred revenue of \$1.3 million as contractual revenue in the fourth quarter of 2016. As a result of Roche's termination of the Roche Agreement, it may be more difficult for us to successfully market, sell and commercialize our products into the markets that Roche would have addressed under the Roche Agreement.

Further, the Roche Agreement provided for additional payments totaling \$40.0 million upon the achievement of certain development milestones, all of which have previously been received and recognized as revenue. Consideration from development milestones is recognized in the period in which a milestone is achieved only if the milestone is considered substantive in its entirety. We achieved the first development milestone under the Roche Agreement and recognized the related \$10.0 million as contractual revenue during the year ended December 31, 2014. We achieved the second and the third (final) development milestones under the Roche Agreement and recognized the related \$10.0 million and \$20.0 million as contractual revenue during the three-month periods ended June 30, 2015 and December 31, 2015, respectively. There are no other milestones remaining to be achieved.

Cash Position

Cash, cash equivalents and investments, excluding restricted cash, at December 31, 2016 totaled \$72.0 million, compared to \$82.3 million at December 31, 2015. During 2016, we received \$58.2 million, net, through the sale of common stock under our “at-the-market” offering. We plan to raise additional capital in the future. To the extent we raise additional funds through the issuance of equity, such issuance will result in dilution to our stockholders. Our cash position is dependent on our revenue, as well as any additional funds raised.

Critical Accounting Policies and Estimates

Management’s Discussion and Analysis of Financial Condition and Results of Operations is based upon our Consolidated Financial Statements, which we have prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”). The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, cost of revenue, and operating expenses, and related disclosure of contingent assets and liabilities. Management based its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements.

Revenue Recognition

Our revenue is generated primarily from the sale of products and services, in addition to revenue from collaboration agreements. Product revenue consists of sales of our instruments and related consumables; Service and other revenue primarily consist of revenue earned from product maintenance agreements, instrument lease agreements and grant revenue. Contractual revenue relates to revenue recognized from the collaboration agreement under which we received an upfront fee and may receive contingent milestone payments. Our deliverables under the arrangement includes licenses to intellectual property rights and research and development services.

We recognize revenue 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. For instances where final acceptance of the product or system is required, revenue is deferred until all acceptance criteria have been met. Revenue for product sales is generally recognized upon customer acceptance. For certain qualified distributors revenue is recognized based upon shipment terms. Revenue for product maintenance agreements is recognized when earned, which is generally ratably over the service period. In order to assess whether the price is fixed or determinable, we evaluate whether refund rights exist. If refund rights exist or payment terms are based on future performance, we defer revenue recognition until the price becomes fixed or determinable. We assess collectability based on a number of factors, including customer creditworthiness. If we determine that collection of amounts due is not reasonably assured, revenue recognition is deferred until receipt of payment.

We regularly enter into arrangements, comprised of one or more contracts, from which revenue is derived from multiple deliverables including a mix of products and or services. Revenue recognition for contracts with multiple deliverables is based on the individual units of accounting determined to exist in the contract. A delivered item is considered a separate unit of accounting when (i) the delivered item has value to the customer on a stand-alone basis; and (ii) if a general right of return exists, the delivery or performance of an undelivered item is considered probable and under our control. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. Our revenue arrangements generally do not have a general right of return. When a deliverable does not meet the criteria to be considered a separate unit of accounting, we group it with other deliverables that, when combined, meet the criteria, and the appropriate allocation of arrangement consideration and revenue recognition is determined. Consideration is allocated at the inception of the contract to all deliverables based on their relative selling price. In order to determine the relative selling price of a deliverable, we apply, in order, vendor-specific objective evidence (“VSOE”); third-party evidence if VSOE is not available; and lastly our best estimate of selling price for the deliverable if neither VSOE nor third-party evidence is available.

In order to establish VSOE, we must regularly sell the product or service on a standalone basis with a substantial majority of sales priced within a relatively narrow range. If an insufficient number of standalone sales exist and VSOE cannot be determined, we then consider whether third party evidence can be used to establish selling price. Due to the lack of similar products and services sold by other companies within our industry, we have not established selling price using third-party evidence. If neither VSOE nor third party evidence of selling price exists, we determine our best estimate of selling price using a combination of prices set by our pricing committee adjusted for applicable discounts and customer orders received to date.

For our collaboration agreement, the process for determining estimates of selling prices of the identifiable deliverables involves significant judgments and estimates to be made by management. Our process considers multiple factors such as estimated headcount, annual research and development budget, estimated length of the research and development period and estimated transfer price on cost,

which may vary over time, depending upon the circumstances, and are specific to each deliverable. If the estimated obligation period of one or more deliverables should change, the future amortization of the revenue would also change.

Deferred service revenue primarily represents product maintenance agreement revenue that is expected to be recognized over the related service period, generally one to three years.

For instrument lease agreements we entered into with our customers so far, they are classified as operating-type leases and revenue from these leases is recognized on a straight-line basis over the respective lease term, once the lessee takes (or has the right to take) control/possession of the property under the lease. Effectively, this occurs once installation is complete and acceptance has been obtained.

We recognize milestone revenues as they become earned. Based on Accounting Standards Codification, or ASC, Topic 605-28, Revenue Recognition — Milestone Method, we evaluate contingent milestones at inception of the agreement, and recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is considered substantive in its entirety. Milestones are considered substantive if the consideration earned from the achievement of the milestone (i) is consistent with performance required to achieve the milestone or the increase in value to the delivered item, (ii) relates solely to past performance and (iii) is reasonable relative to all of the other deliverables and payments within the arrangement.

Cost of Revenue

Cost of revenue reflects the direct cost of product components, third-party manufacturing services and our internal manufacturing overhead and customer service infrastructure costs incurred to produce, deliver, maintain and support our instruments, consumables, and services. There are no incremental costs associated with our contractual revenue; all product development costs are reflected in research and development expense.

Manufacturing overhead is predominantly comprised of labor and facility costs. We determine and capitalize manufacturing overhead into inventory based on a standard cost model that approximates actual costs. Prior to achieving manufacturing volumes that correlated with our estimated normal capacity (the production levels expected to be achieved over a number of periods under normal circumstances with available resources), we based our capitalized overhead relative to our normal capacity. Prior to achieving normal capacity, excess manufacturing resources were engaged in research and development activities, including; next generation products, internal use research products, and general support activities. As such, manufacturing costs in excess of amounts reflected in inventory were expensed as a component of research and development expense. During 2014, manufacturing volumes trended towards and then approximated normal capacity, and excess manufacturing resources contributing to research and development activities declined significantly.

Service costs include the direct costs of components used in support, repair and maintenance of customer instruments as well as the cost of personnel, materials, shipping and support infrastructure necessary to support the installed customer base. Prior to the fourth quarter of 2013, the capacity of our existing service infrastructure exceeded the number of installed customer instruments. Therefore, management estimated the capacity of the existing service infrastructure and recognized the service-related cost of revenue based on the installed base. As a result, prior to the fourth quarter of 2013, total service infrastructure costs exceeded the costs associated with the support of customer instruments and such excess costs were included as a component of sales, general and administrative expense.

Stock-Based Compensation

Stock-based compensation expense for all stock-based compensation awards is based on the grant date fair value estimated using the Black-Scholes option pricing model. We have limited historical information available to support the underlying estimates of certain assumptions required to value stock options. The expected term of options is estimated based on the simplified method. We do not have sufficient trading history to solely rely on the volatility of our own common stock for establishing expected volatility. Therefore, we based our expected volatility on the historical stock volatilities of our common stock as well as several comparable publicly listed companies over a period equal to the expected term of the options. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the stock option. We estimate our forfeiture rate based on an analysis of our actual forfeitures and will continue to evaluate the adequacy of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover behavior and other factors. The impact from a forfeiture rate adjustment will be recognized in full in the period of adjustment, and if the actual number of future forfeitures differs from that estimated, we may be required to record adjustments to stock-based compensation expense in future periods. We recognize compensation expense on a straight-line basis over the requisite service period. We elected to use the simplified method to calculate the beginning pool of excess tax benefits.

The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, if our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

Impairment of Long-lived Assets

We assess impairment of long-lived assets, which include property and equipment, on at least an annual basis and when events or changes in circumstances indicate that their carrying amount may not be recoverable. Circumstances which could trigger a review include, but are not limited to, significant decreases in the market price of the asset, significant adverse changes in the business climate or legal factors, accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset, current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset, or expectations that the asset will more likely than not be sold or disposed of significantly before the end of its estimated useful life. To date we have not recorded any impairment charges.

Inventories

Inventory is valued at the lower of standard cost, which approximates actual cost, or market. Cost is determined using the first-in, first-out (“FIFO”) method. Adjustments to reduce the cost of inventory to its net realizable value, if required, are made for estimated excess or obsolete balances.

We enter into inventory purchases and commitments so that we can meet future shipment schedules based on forecasted demand for our products. The business environment in which we operate is subject to rapid changes in technology and customer demand. We perform a detailed assessment of inventory each period, which includes a review of, among other factors, demand requirements, product life cycle and development plans, component cost trends, product pricing, product expiration, and quality issues. Based on our analysis, we record adjustments to inventory for potentially excess, obsolete, or impaired goods, when appropriate, in order to report inventory at net realizable value. Inventory adjustments may be required if actual demand, component costs, supplier arrangements, or product life cycles differ from our estimates. Any such adjustments would result in a charge to our results of operations.

Leases

We categorize leases at their inception as either operating or capital leases. On certain of our lease agreements, we received tenant improvement allowances, rent holidays and/or other incentives. Rent expense is recorded on a straight-line basis over the term of the lease. The difference between rent expense accrued and amounts paid under the lease agreement is recorded as deferred rent in the accompanying balance sheets. Leasehold improvements are capitalized at cost and depreciated over the shorter of their expected useful life or the life of the lease. To the extent leasehold improvement allowances are afforded to us by the landlord, we record the tenant improvements as leasehold improvement assets with a corresponding deferred rent liability. We establish assets and liabilities for the construction costs incurred under build-to-suit lease arrangements to the extent we are involved in the construction of structural improvements or take some level of financial or construction risk prior to commencement of a lease.

For build-to-suit lease arrangements, we evaluate the extent of our financial and operational involvement in the tenant improvements to determine whether we are considered the owner of the construction project under U.S. GAAP. When we are considered the owner of a project, we record the shell of the facility at its fair value at the date construction commences with a corresponding facility financing obligation. Improvements to the facility during the construction

project are capitalized and, to the extent funded by lessor afforded incentives, with corresponding increases to the facility financing obligation. Payments we make under leases in which we are considered the owner of the facility are allocated to land rental expense, based on the relative values of the land and building at the commencement of construction, reductions of the facility financing obligation and interest expense recognized on the outstanding obligation. To the extent gross future payments do not equal the recorded liability, the liability is settled upon return of the facility to the lessor. Any difference between the book value of the assets and remaining facility obligation are recorded in other income (expense), net. For existing arrangements, the differences are expected to be immaterial.

Income Taxes

We are subject to income taxes in the United States and certain states in which we operate, and we use estimates in determining our provisions for income taxes. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and valuation allowances recorded against net deferred tax assets in accordance with U.S. GAAP. These estimates and judgments occur in the calculation of tax credits, benefits, and deductions, and in the calculation of certain tax assets and liabilities, which arise from differences in the timing of recognition of revenue and expense for tax and financial statement purposes, as well as the interest and penalties related to uncertain tax positions. Significant changes to these estimates may result in an increase or decrease to our tax provision in the current or subsequent period.

At December 31, 2016, we maintained a full valuation allowance against all of our deferred tax assets which totaled \$317.4 million, including net operating loss carryforwards and research and development tax credits of \$264.2 million and \$32.0 million, respectively. Our deferred tax assets include federal and state net operating loss carryforwards of approximately \$684.0 million and \$574.1 million, respectively, and federal and state research and development credit carryforwards of approximately \$26.9 million and \$29.0 million, respectively. The federal net operating loss carryforward begins expiring in 2024, the state net operating loss carryforward have expirations in 2016 and beyond, the federal research and development credits begin expiring in 2024 and the California tax research and development credits can be carried forward indefinitely.

We assess all material positions taken in any income tax return, including all significant uncertain positions, in all tax years that are still subject to assessment or challenge by relevant taxing authorities. Assessing an uncertain tax position begins with the initial determination of the position's sustainability and is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and we will determine whether the factors underlying the sustainability assertion have changed and the amount of the recognized tax benefit is still appropriate.

Recent Accounting Pronouncements

Recently Adopted Accounting Standards

In July 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-11, Simplifying the Measurement of Inventory, which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost and net realizable value test. ASU 2015-11 is effective for annual report periods beginning after December 15, 2016 and is effective for us in the first quarter of 2017. We have elected to early adopt ASU 2015-11 effective beginning with the three-month period ended March 31, 2016, as permitted by the standard. The early adoption of this update did not have a material impact on our condensed consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements – Going Concern Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern, which requires management to evaluate whether there are conditions or events that raise substantial doubt about an entity's ability to continue as a going concern and to provide disclosures when certain criteria are met. The guidance is effective for annual periods beginning after December 15, 2016 and interim reporting periods starting in the first quarter of 2017. We adopted this standard as of December 31, 2016.

Recently Issued Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which amends the current stock compensation guidance. The amendments simplify the accounting for the taxes related to stock based compensation, including adjustments to how excess tax benefits and a company's payments for tax withholdings should be classified. Furthermore, the amendments allow the entities to make an accounting policy election to either estimate forfeitures or recognize forfeitures as they occur. If an election is made, the change to recognize forfeitures as they occur must be adopted using a modified retrospective approach with a cumulative effect adjustment recorded to opening retained earnings. The standard is effective for fiscal periods beginning after December 15, 2016, with early adoption permitted. We are currently evaluating which forfeiture method to use. In either scenario it will not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases. The guidance in ASU 2016-02 supersedes the lease recognition requirements in ASC Topic 840, Leases. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease for both financing and operating leases, along with additional qualitative and quantitative disclosures. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or the cumulative effect transition method. ASU 2014-09 is effective for periods beginning after December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of 2018. We are currently evaluating the new guidance to determine the impact it may have on our consolidated financial statements.

While we are continuing to assess all potential impacts of the new accounting standard, we currently believe the most significant impact relates to our accounting for incremental cost of obtaining a contract with a customer (i.e. sales commission). Under current GAAP, the cost incurred to obtain a contract is recognized in the period the expense is incurred while under the new standard, the incremental costs to obtain the contract will be allocated to the performance obligations using the relative fair value of these obligations, recognized as an asset and amortized over the useful life of that asset. We are still in the process of evaluating the impact of this new standard on these arrangements. Due to the complexity of certain of our contracts, the actual revenue recognition treatment required under the new standard for these arrangements may be dependent on contract-specific terms and vary in some instances.

Results of Operations

Comparison of the Years Ended December 31, 2016 and 2015

	Year Ended December			
	31,			
	2016	2015	\$ Change	% Change
Revenue:	(in thousands, except percentages)			
Product revenue	\$ 64,609	\$ 37,502	\$ 27,107	72%
Service and other revenue	13,971	10,896	3,075	28%
Contractual revenue	12,134	44,384	(32,250)	(73%)
Total revenue	90,714	92,782	(2,068)	(2%)
Cost of Revenue:				
Cost of product revenue	34,512	30,704	3,808	12%
Cost of service and other revenue	12,042	8,628	3,414	40%
Total cost of revenue	46,554	39,332	7,222	18%
Gross profit	44,160	53,450	(9,290)	(17%)
Operating Expense:				
Research and development	67,617	60,440	7,177	12%
Sales, general and administrative	47,787	45,187	2,600	6%

Gain on lease amendments	—	(23,043)		
Total operating expense	115,404	82,584	32,820	40%
Operating loss	(71,244)	(29,134)	(42,110)	(145%)
Interest expense	(3,234)	(2,926)	(308)	(11%)
Other income (expense), net	103	364	(261)	(72%)
Net loss	\$ (74,375)	\$ (31,696)	\$ (42,679)	(135%)

Revenue

	Year Ended			
	December 31,			
	2016	2015	\$ Change	% Change
Revenue:	(in thousands, except percentages)			
Instrument revenue	\$ 40,956	\$ 18,728	\$ 22,228	119%
Consumable revenue	23,653	18,774	4,879	26%
Total product revenue	64,609	37,502	27,107	72%
Service and other revenue	13,971	10,896	3,075	28%

Contractual revenue	12,134	44,384	(32,250)	(73%)
Total revenue	\$ 90,714	\$ 92,782	(2,068)	(2%)

Total revenue for the year ended December 31, 2016 was \$90.7 million compared to \$92.8 million for 2015.

Product revenue for the year ended December 31, 2016 consisted of \$41.0 million from sales of instruments and \$23.7 million from sales of consumables, for total product revenues of \$64.6 million, compared to \$18.7 million from sales of instruments and \$18.8 million from sales of consumables, for total product revenue of \$37.5 million for the year ended December 31, 2015. The increase in sales of instruments from 2015 to 2016 included the effects of the product transition from the PacBio RS II System to the Sequel System. The increase in consumable sales from 2015 to 2016 was primarily attributable to a larger installed instrument base. We expect product revenue to increase in 2017 compared to 2016 based on an expected increase in system shipments and an expected increase in Sequel System utilization.

Service and other revenue for the year ended December 31, 2016 was \$14.0 million compared to service revenue of \$10.9 million for the year ended December 31, 2015. The increase in service revenue from 2015 to 2016 was primarily attributable to a larger installed instrument base in 2016.

Contractual revenue for the year ended December 31, 2016 was \$12.1 million compared to \$44.4 million for 2015. Contractual revenue for 2016 included amortization of \$3.6 million of the upfront Roche payment for each of the first three quarters of 2016, plus amortization of \$1.3 million for the fourth quarter of 2016. As of December 31, 2016, the upfront Roche payment of \$35.0 million has been fully recognized. Contractual revenue for 2015 included amortization of \$3.6 million of the upfront Roche payment for each of the four quarters of 2015, plus \$30.0 million of payments associated with development milestones under the Roche Agreement. We do not expect any contractual revenue for 2017.

Gross Profit

Gross profit for the year ended December 31, 2016 totaled \$44.2 million, resulting in a gross margin of 48.7%, compared to a \$53.5 million gross profit for the year ended December 31, 2015 and a gross margin of 57.6%. The gross profit and margin for the year ended December 31, 2015 included \$30.0 million of milestone revenue from the Roche Agreement at a 100% margin. Excluding this milestone revenue, gross profit and gross margin for the year ended December 31, 2016 increased significantly over 2015 primarily as a result of the higher margin sales of the Sequel System, which was launched in the fourth quarter of 2015.

Cost of product revenue increased to \$34.5 million for the year ended December 31, 2016, compared to cost of product revenue of \$30.7 million for 2015. The increase in cost of product revenue was primarily driven by the growth of instrument and consumable shipments in 2016 compared to 2015.

Cost of service and other revenue for the year ended December 31, 2016 increased to \$12.0 million compared to \$8.6 million for the year ended December 31, 2015. The cost of service and other revenue increased in line with the growth in revenue but was partially offset by leveraging existing infrastructure.

Gross margin for 2017 is expected to be lower than 2016, as we have no scheduled contractual revenue to amortize in 2017.

Research and Development Expense

For the year ended December 31, 2016, research and development expenses increased by \$7.2 million, or 11.9%, compared to the year ended December 31, 2015. The increase in research and development expenses was primarily attributed to an increase of \$6.9 million in compensation related expenses resulting from increased headcount and higher stock-based compensation expenses and an increase of \$1.4 million in product development costs related to the launch of the Sequel System, partially offset by a decrease of \$1.0 million in professional fees. Research and development expenses included stock-based compensation expenses of \$8.3 million and \$5.2 million for the years ended December 31, 2016 and 2015, respectively.

We expect our total research and development expenses to increase in 2017 compared to 2016.

Sales, General and Administrative Expense

For the year ended December 31, 2016, sales, general and administrative expenses increased by \$2.6 million, or 5.8%, compared to the year ended December 31, 2015. The increase in sales, general and administrative expenses was primarily attributed to an increase of \$3.8 million in compensation related expenses resulting from increased headcount and higher stock-based compensation expenses, partially offset by a decrease of \$1.1 million in facility expenses due to the rent abatements in 2016. Sales, general and administrative expenses included stock-based compensation expenses of \$9.2 million and \$7.3 million for the years ended December 31, 2016 and 2015, respectively.

We expect our sales, general and administrative expenses to increase in 2017 compared to 2016.

Interest Expense

Interest expense for the year ended December 31, 2016 remained flat compared to 2015. Interest expense related primarily to the debt facility that we entered into in February 2013.

Comparison of the Years Ended December 31, 2015 and 2014

	Year Ended December 31,			
	2015	2014	\$ Change	% Change
Revenue:	(in thousands, except percentages)			
Product revenue	\$ 37,502	\$ 35,299	\$ 2,203	6%
Service and other revenue	10,896	8,511	2,385	28%
Contractual revenue	44,384	16,784	27,600	164%
Total revenue	92,782	60,594	32,188	53%
Cost of Revenue:				
Cost of product revenue	30,704	29,626	1,078	4%
Cost of service and other revenue	8,628	7,566	1,062	14%
Total cost of revenue	39,332	37,192	2,140	6%
Gross profit	53,450	23,402	30,048	128%
Operating Expense:				
Research and development	60,440	48,230	12,210	25%
Sales, general and administrative	45,187	38,026	7,161	19%
Gain on Lease amendments	(23,043)	—	(23,043)	
Total operating expense	82,584	86,256	(3,672)	(4%)
Operating loss	(29,134)	(62,854)	33,720	54%
Interest expense	(2,926)	(2,828)	(98)	(3%)
Other income (expense), net	364	(478)	842	176%
Net loss	\$ (31,696)	\$ (66,160)	\$ 34,464	52%

Total revenue for the year ended December 31, 2015 was \$92.8 million compared to \$60.6 million for 2014.

Product revenue for the year ended December 31, 2015 consisted of \$18.7 million from sales of instruments and \$18.8 million from sales of consumables, compared to \$22.1 million from sales of instruments and \$13.2 million from sales of consumables for the year ended December 31, 2014. The decrease in sales of instruments from 2014 to 2015 included the effects of the product transition from the PacBio RS II System to the Sequel System. The increase in consumable sales from 2014 to 2015 was primarily attributable to a larger installed instrument base and higher utilization of installed instruments by our customers.

Service and other revenue for the year ended December 31, 2015 primarily consisted of service revenue of \$10.9 million compared to service revenue of \$8.5 million for the year ended December 31, 2014. Service revenue was, and continues to be, derived from product maintenance agreements sold on our installed instruments. The increase in service revenue from 2014 to 2015 was primarily attributable to a larger installed instrument base in 2015.

Contractual revenue includes \$14.4 million and \$6.8 million for the years ended December 31, 2015 and 2014, respectively, from the amortization of the non-refundable up-front payment of \$35.0 million we received during September 2013 pursuant to the Roche Agreement. Contractual revenue for 2015 included an additional \$7.6 million, compared to the prior year, reflecting the increased certainty of the estimated development time period. We achieved the first development milestone under the Roche Agreement and recorded the related \$10.0 million as contractual revenue during the year ended December 31, 2014. We achieved the second and third (final) development milestones under the Roche Agreement and recognized the related \$10.0 million and \$20.0 million, respectively, as contractual revenue during the year ended December 31, 2015.

Gross Profit

Gross profit for the year ended December 31, 2015 totaled \$53.5 million, resulting in a gross margin of 57.6%, compared to a \$23.4 million gross profit for the year ended December 31, 2014 and a gross margin of 38.6%. Both gross profit and gross margin in 2015 increased over 2014 as a result of the growth described above in consumable revenue, which has higher margins, and in contractual revenue, which has a gross margin of 100%.

Cost of product revenue increased to \$30.7 million for the year ended December 31, 2015, compared to cost of product revenue of \$29.6 million for 2014. The increase in cost of product revenue was primarily driven by the growth of consumable shipments.

Cost of service and other revenue for the year ended December 31, 2015 increased to \$8.6 million compared to \$7.6 million for the year ended December 31, 2014. The cost of service and other revenue increased in line with the growth in revenue but was partially offset by leveraging existing infrastructure.

Research and Development Expense

For the year ended December 31, 2015, research and development expenses increased \$12.2 million, or 25%, compared to the year ended December 31, 2014. The increase in research and development expenses was primarily attributed to an increase of \$6.7 million in product development costs related to the launch of the Sequel System and higher compensation related expenses resulting from increased headcount and higher stock-based compensation expenses. Research and development expenses included stock-based compensation expenses of \$5.2 million and \$3.8 million for the years ended December 31, 2015 and 2014, respectively.

Sales, General and Administrative Expense

For the year ended December 31, 2015, sales, general and administrative expenses increased \$7.2 million, or 19%, compared to the year ended December 31, 2014. The increase in sales, general and administrative expenses was primarily attributed to an increase of \$5.3 million in compensation related expenses resulting from increased headcount and higher stock-based compensation expenses and an increase of \$2.1 million in professional fees, of which \$1.2 million was primarily related to fees associated with the final Roche milestone payment of \$20.0 million recognized during the fourth quarter of 2015. Sales, general and administrative expenses included stock-based compensation expenses of \$7.3 million and \$5.4 million for the years ended December 31, 2015 and 2014, respectively.

Gain on Lease Amendments

On July 23, 2015, we entered into a Lease Amendment Agreement (the "Lease Amendment Agreement") with Peninsula Innovation Partners, LLC (the "Existing Landlord"), which amends the terms and conditions of certain of our existing Menlo Park facility real property leases. The Lease Amendment Agreement provides for, among other things, amendments of the term for certain of the existing leases, the termination of all renewal, expansion and extension rights contained in any of the existing leases with the Existing Landlord (including our options to extend the terms for certain of the existing leases for two consecutive five-year periods), as well as rent abatement for a specified period of time. As consideration for our agreement to amend the existing leases pursuant to the Lease Amendment Agreement, and subject to the terms and conditions contained therein, we are eligible to receive up to four payments of \$5.0 million each from the Existing Landlord over time (the "Landlord Payments"), and rent abatement for the remainder of the lease. In the event that we breach any of the leases and fail to cure such breach within the time permitted, the Existing Landlord would have no obligation to make the final \$5.0 million payment. On September 1, 2015 the permitting process related to an architectural approval and a change of use permit with respect to the O'Brien Premises was completed and the related contingencies satisfied. As a result, we recorded \$23.0 million in "Gain on lease amendments" in the consolidated statements of operations and comprehensive loss for the year ended December 31, 2015, reflecting that our rent payments were reduced to zero for the remaining term of our existing Menlo Park facility real property leases, the aggregate of \$20.0 million in Landlord Payments became receivable and any associated financing obligation was revalued.

Interest Expense

Interest expense for the year ended December 31, 2015 remained flat compared to 2014. Interest expense related primarily to the debt facility entered into in February 2013.

Liquidity and Capital Resources

Liquidity

Since our inception, we have financed our operations primarily through product sales, issuance of common stock and convertible preferred stock, in addition to our debt facility and payments from Roche pursuant to the terms of the Roche Agreement. Cash, cash equivalents and investments, excluding restricted cash, at December 31, 2016 totaled \$72.0 million, compared to \$82.3 million at December 31, 2015.

We believe that our existing cash, cash equivalents and investments will be sufficient to fund our projected operating requirements for at least 12 months; however, we plan to raise additional capital in the future. These expectations are based on our current operating and financing plans which are subject to change. Factors that may affect our capital needs include, but are not limited to, slower than expected adoption of our products resulting in lower sales of our products and services; future acquisitions; our ability to obtain new collaboration agreements and maintain customer arrangements; the progress of our research and development programs; initiation or expansion of research programs and collaborations; the costs involved in preparing, filing, prosecuting, defending and enforcing

intellectual property rights; the costs of being a public company; the purchase of patent licenses; the costs associated with the ongoing transition to our new facilities in Menlo Park, California; regulatory costs; and other factors.

To the extent we raise additional funds through the sale of equity or convertible debt securities, the issuance of such securities will result in dilution to our stockholders. There can be no assurance that such funds will be available on favorable terms, or at all. If adequate funds are not available, we may be required to curtail operations significantly or to obtain funds by entering into collaboration agreements on unattractive terms. Our inability to raise capital could have a material adverse effect on our business, financial condition and results of operations.

The following table summarizes our cash flow activities for the periods indicated:

(in thousands)	Year Ended December 31,		
	2016	2015	2014
Net cash provided by (used in):			
Operating activities	\$ (67,929)	\$ (47,889)	\$ (51,468)
Investing activities	(14,864)	8,606	19,564
Financing activities	65,929	36,463	41,991

Operating Activities

Our primary uses of cash in operating activities are for the development of ongoing product enhancements and future products, manufacturing, and support functions related to our sales, general and administrative activities. The net cash used for the years ended December 31, 2016, 2015 and 2014 primarily reflected the net loss for those periods, partially offset by non-cash operating expenses including depreciation and stock-based compensation, as well as changes in working capital.

Cash used in operating activities of \$67.9 million in 2016 reflected a net loss of \$74.4 million, adjusted for non-cash items such as stock-based compensation of \$19.6 million, depreciation and amortization of \$3.9 million and amortization of debt discount and financing costs of \$1.2 million. Additionally, the change in net operating assets and liabilities was attributed to a reduction in deferred contractual revenue of \$12.1 million, an increase in inventory of \$6.2 million and an increase of accounts receivable of \$6.2 million, partially offset by an increase of \$4.5 million of accounts payable and accrued expenses due primarily to the timing of payments. The change in inventory also reflects a transfer of \$1.3 million from inventory to fixed assets relating to our instruments.

Cash used in operating activities of \$47.9 million in 2015 reflected a net loss of \$31.7 million, adjusted for non-cash items such as stock-based compensation of \$13.8 million, depreciation and amortization of \$3.7 million, the non-cash portion relating to the gain on lease amendments of \$3.0 million, and amortization of debt discount and financing costs of \$1.0 million. Additionally, the change in net operating assets and liabilities was attributed to an increase of prepaid expenses and other assets of \$17.9 million, of which a \$15.0 million increase related to the future landlord

payments associated with the Lease Amendment Agreement that we entered into in 2015 for our prior headquarters, a reduction in deferred contractual revenue of \$14.4 million and a decrease in inventory of \$2.5 million, offset by an increase of \$5.0 million of accounts payable and accrued expenses due primarily to the timing of payments. The change in inventory also reflects a transfer of \$2.8 million from inventory to fixed assets relating to leased PacBio RS II instruments.

Cash used in operating activities of \$51.5 million in 2014 reflected a net loss of \$66.2 million, partially offset by non-cash, stock-based compensation of \$9.9 million and depreciation and amortization of \$4.2 million. The change in net operating assets and liabilities was primarily due to an increase of \$3.9 million in accounts payable and an increase of \$3.5 million in accrued expenses, partially offset by a decrease of \$6.8 million in deferred contractual revenue during 2014.

Investing Activities

Our investing activities consist primarily of capital expenditures and investment purchases and maturities.

In 2016, net cash used in investing activities was \$14.9 million, comprised of net purchase of investments of \$6.7 million and net purchase of property and equipment of \$8.2 million.

In 2015, net cash provided by investing activities was \$8.6 million, comprised of \$16.1 million in net maturities and sales of investments, partially offset by \$3.0 million in net purchases of property and equipment, and \$4.5 million in long-term restricted cash related to a letter of credit established in October 2015 associated with the lease agreement for our current headquarters.

In 2014, net cash provided by investing activities was \$19.6 million, comprised of \$21.2 million in net maturities of investments, partially offset by \$1.6 million in purchases of property and equipment.

Financing Activities

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In 2016, cash provided by financing activities was \$65.9 million, comprised of net proceeds of \$58.2 million from our common stock “at-the-market” offering program and \$7.7 million from the issuance of common stock through our equity compensation plans.

In 2015, cash provided by financing activities was \$36.5 million, comprised of net proceeds of \$29.1 million from our common stock “at-the-market” offering program and \$7.4 million from the issuance of common stock through our equity compensation plans.

In 2014, cash provided by financing activities was \$42.0 million, comprised of net proceeds of \$38.0 million from our common stock “at-the-market” offering program and \$4.0 million from the issuance of common stock through our equity compensation plans.

Capital Resources

Common Stock “At-the-Market” Offering

On October 5, 2012, we entered into a sales agreement pursuant to which we sold shares of our common stock having an aggregate offering price of approximately \$30.0 million through an “at-the-market” offering.

On November 8, 2013, we amended the sales agreement to increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On February 3, 2015, we amended the sales agreement again in order to further increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On February 3, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Such aggregate offering price of shares of our common stock was in addition to the shares sold under the original sales agreement, dated October 5, 2012, the first amendment to the sales agreement, dated November 8, 2013, and the second amendment to the sales agreement, dated February 3, 2015. Pursuant to the prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On May 18, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Pursuant to such prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On February 2, 2017, we filed an additional prospectus supplement pursuant to which we may offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$60.0 million under the sales agreement.

We may need to raise additional capital in the future through the sale of equity or convertible debt securities, including future “at-the-market” offerings.

We pay a commission equal to 3% of the gross proceeds from the sale of shares of our common stock under the sales agreement. We are not obligated to sell shares of our common stock under the sales agreement.

Debt Facility Agreement

Under the terms of our February 2013 debt agreement with Deerfield (the “Facility Agreement”), we received \$20.5 million and issued promissory notes in the aggregate principal amount of \$20.5 million (the “Notes”). The Notes bear simple interest at a rate of 8.75% per annum, payable quarterly in arrears commencing on April 1, 2013 and on the first business day of each January, April, July and October thereafter. The Facility Agreement has a maximum term of seven years. We received net proceeds of \$20.0 million, representing \$20.5 million of gross proceeds, less a \$500,000 facility fee, before deducting other expenses of the transaction.

The Facility Agreement also contains various representations and warranties, and affirmative and negative covenants, customary for financings of this type, including restrictions on our ability to incur additional indebtedness or liens on our assets, except as permitted under the Facility Agreement. In addition, the Facility Agreement requires us to maintain consolidated cash and cash equivalents on the last day of each calendar quarter of not less than \$2.0 million. As security for our repayment of our obligations under the Facility Agreement, we granted the lenders a security interest in substantially all of our property and interests in property.

Subject to certain exceptions set forth in the Facility Agreement, holders representing a majority of the aggregate principal amount of the outstanding Notes issued pursuant to the Facility Agreement may elect to receive 25% of the net proceeds from any financing that includes an equity component. To the extent we raise additional capital in the future through the sale of common stock, including without limitation, sales of common stock pursuant to an “at-the-market” offering program, we may be obligated, at the election of the holders of the Notes, to pay 25% of the net proceeds from any such financing activities as partial payment of the Notes.

Contractual Obligations, Commitments and Contingencies

Leases

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In December 2009, we entered into a lease agreement for a manufacturing and office facility in Menlo Park. In order for the facility to meet our needs and operating requirements, substantial tenant improvements, including improvements to the structural elements and principal operating systems of the facility, were necessary. The lessor provided a tenant improvement allowance of \$1.8 million to apply towards the necessary improvements and we remained obligated for additional amounts over the afforded allowance. Due to our involvement in and the nature of the renovations made to the facility and our obligations to fund the costs of renovations exceeding the incentives afforded to us, we account for the facility as if we are the owner. Accordingly, we recorded \$3.0 million of building and leasehold improvement assets, reflecting the \$1.2 million fair value of the facility prior to commencing renovations and the \$1.8 million of landlord incentives within property and equipment, net and a corresponding liability recorded to facility financing obligation.

As a result of the lease amendment agreement described below, future rent expense associated with our existing Menlo Park facility leases was reduced to zero. The remaining long-term facility financing obligations associated with these leases, presented as “Other liabilities, non-current” on the consolidated balance sheets at December 31, 2016 and December 31, 2015, were \$1.7 million and \$1.4 million, respectively.

Lease Amendment Agreement

On July 23, 2015, we entered into the Lease Amendment Agreement with the Existing Landlord, which amends the terms and conditions of certain of our existing Menlo Park facility real property leases. The Lease Amendment Agreement provides for, among other things, amendments of the term for certain of the leases with the Existing Landlord, the termination of all renewal, expansion and extension rights contained in any of the existing leases with the Existing Landlord (including our options to extend the terms for certain of the existing leases for two consecutive five-year periods), as well as rent abatement for a specified period of time. As consideration for our agreement to amend the existing leases pursuant to the Lease Amendment Agreement, and subject to the terms and conditions contained therein, we became eligible to receive up to four payments of \$5.0 million each from the Existing Landlord over time (the “Landlord Payments”), and rent abatement for the remainder of the lease. In the event that we breach any of the leases and fail to cure such breach within the time permitted, the Existing Landlord would have no obligation to make the final \$5.0 million payment. On September 1, 2015, the permit process related to an architectural approval and a change of use permit with respect to our new O’Brien Premises was completed, which satisfied the contingencies under the Lease Amendment Agreement. As a result, we recorded \$23.0 million in “Gain on lease amendments” in the consolidated statements of operations and comprehensive loss for the three-month period ended September 30, 2015, reflecting that our rent payments were reduced to zero for the remaining term of our existing Menlo Park facility real property leases, and the aggregate of \$20.0 million in Landlord Payments became receivable and any associated financing obligation was revalued. Of the \$20.0 million remaining Landlord Payments, the first \$5.0 million Landlord Payment was received in September 2015, the second \$5.0 million Landlord Payment was received in February 2016 and the third \$5.0 million Landlord Payment was received in August 2016.

In June 2016, we entered into a Second Lease Amendment Agreement with the Existing Landlord that modified the payment schedule for the final \$5.0 million. At December 31, 2016, the final \$5.0 million was recorded in “Prepaid Expenses and Other Current Assets” in the consolidated balance sheets. We do not believe that there are any remaining performance obligations relating to the remaining Landlord Payments. In January 2017, we entered into a Third Lease Amendment Agreement with the Existing Landlord that increased the amount of the payments receivable from the Existing Landlord by \$65,000. In February 2017, we received \$1,045,000 out of the total receivable of \$5,065,000 from the Existing Landlord.

O’Brien Lease Agreement

On July 22, 2015, we entered into the O'Brien Lease with respect to the O'Brien Premises. The term of the O'Brien Lease is one hundred thirty-two (132) months, commencing on the date that is the later of April 15, 2016 or the date on which the O'Brien Premises landlord has substantially completed certain shell improvements and tenant improvements. In December 2016, we entered into an amendment to the O'Brien Lease which defined the commencement date of the lease to be October 25, 2016, notwithstanding that such substantial completion date had not yet occurred. We did not have control of the building until after December 31, 2016. Base monthly rent will be abated for the first six (6) months of the lease term and thereafter will be \$540,000 per month during the first year of the lease term, with specified annual increases thereafter until reaching \$711,000 per month during the last twelve (12) months of the lease term. We were required to pay \$2,160,000 in prepaid rent which will be applied to the monthly rent installments due for the first to fourth months after the rent abatement period. We were required to establish a deposit of \$4.5 million in the form of a letter of credit in October 2015; and, as such, \$4.5 million was recorded in "Long-term restricted cash" in the consolidated balance sheet as of both December 31, 2016 and December 31, 2015. The landlord is obligated to construct certain shell improvements at the landlord's cost and expense and provide us with improvement allowances in the amount of \$12.6 million.

Under the O'Brien Lease, we expect to pay approximately \$79.2 million in rent and \$24 million in operating expenses over the expected lease term. In addition to the lease payments, we are also required to reimburse the landlord for certain improvement costs in excess of the tenant improvement allowances provided. These improvement costs, along with the costs associated with the anticipated move to the O'Brien Premises, are expected to be substantial in nature. These future expenditures are expected to be partially offset by the \$5.1 million of future Landlord Payments from our Existing Landlord as described above.

The following table provides summary information concerning our future contractual obligations as of December 31, 2016:

	Payments due by period (in thousands)						
	Total	2017	2018	2019	2020	2021	After
Operating lease obligations (1)	\$ 79,486	\$ 4,569	\$ 6,949	\$ 6,930	\$ 7,056	\$ 7,272	\$ 46,710
Debt (2)	25,837	1,794	5,375	2,816	15,852	—	—
Purchase commitments and obligations	18,041	18,041	—	—	—	—	—
Total contractual obligations	\$ 123,364	\$ 24,404	\$ 12,324	\$ 9,746	\$ 22,908	\$ 7,272	\$ 46,710

(1) Maintenance, insurance, taxes and contingent rent obligations are excluded. See “Note 7. Commitments and Contingencies” in Part II, Item 8 of this Form 10-K for additional information.

(2) Under the terms of the Facility Agreement and the Notes, we received \$20.5 million in funding. The amounts in the table above include interest and principal repayments on the debt.

Purchase Commitments and Obligations

These amounts include an estimate of all open purchase orders and contractual obligations in the ordinary course of business, including commitments with contract manufacturers and suppliers, for which we have not received the goods or services. A majority of these purchase obligations are due within a year. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

The table above reflects only payment obligations that are fixed and determinable. Future milestone payments and royalties under our license agreements are not included in the table above because we cannot, at this time, determine when or if the events triggering any such payment obligations will occur or the amounts that will become potentially payable.

License Agreements

Payments related to licensing and other arrangements not included in the contractual obligations table include amounts related to cancelable license agreements with third parties for certain patent rights and technology. Under the terms of these agreements, we may be obligated to pay royalties based on revenue from the sales of licensed products, or minimum royalties, whichever is greater, and license maintenance fees. The future license maintenance fees and minimum royalty payments under the license agreements are not deemed to be material.

Legal Proceedings

On November 2, 2016, we filed a complaint against ONT with the USITC for patent infringement. On December 5, 2016, the USITC provided notice that an investigation had been instituted based on the complaint. We are seeking

exclusionary relief with respect to several ONT products, including ONT's MinION and PromethION devices. The complaint is based on our U.S. Patent No. 9,404,146, entitled "Compositions and methods for nucleic acid sequencing" which covers novel methods for sequencing single nucleic acid molecules using linked double-stranded nucleic acid templates, providing improved sequencing accuracy. We have notified the Commission of our intention to add a second patent in the same patent family, U.S. Patent No. 9,542,527, which was granted on January 10, 2017, to the investigation. We are seeking, among other things, an exclusion order permanently barring entry of infringing ONT products into the United States, and a cease and desist order preventing ONT from advertising and selling infringing products in the United States.

From time to time, we may also be involved in a variety of other claims, lawsuits, investigations and proceedings relating to securities laws, product liability, patent infringement, contract disputes, employment and other matters that arise in the normal course of our business. In addition, third parties may, from time to time, assert claims against us in the form of letters and other communications. We record a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We currently do not believe that the ultimate outcome of any of the matters described above is probable or reasonably estimable, or that these matters will have a material adverse effect on our business; however, the results of litigation and claims are inherently unpredictable. Regardless of the outcome, litigation can have an adverse impact on us because of litigation and settlement costs, diversion of management resources and other factors.

Off-Balance Sheet Arrangements

As of December 31, 2016 we did not have any off-balance sheet arrangements.

In the ordinary course of business, we enter into standard indemnification arrangements. Pursuant to these arrangements, we indemnify, hold harmless, and agree to reimburse the indemnified parties for losses suffered or incurred by the indemnified party in connection with any trade secret, copyright, patent or other intellectual property infringement claim by any third party with respect to its technology, or from claims relating to our performance or non-performance under a contract, any defective products supplied by us, or any negligent acts or omissions, or willful misconduct, committed by us or any of our employees, agents or representatives. The term of these indemnification agreements is generally perpetual after the execution of the agreement. The maximum potential amount of future payments we could be required to make under these agreements is not determinable because it involves claims that may be made against us in future periods, but have not yet been made. To date, we have not incurred costs to defend lawsuits or settle claims related to these indemnification agreements.

We also enter and have entered into indemnification agreements with our directors and officers that may require us to indemnify them against liabilities that arise by reason of their status or service as directors or officers, except as prohibited by applicable law. In addition, we may have obligations to hold harmless and indemnify third parties involved with our fundraising efforts and their respective affiliates, directors, officers, employees, agents or other representatives against any and all losses, claims, damages and liabilities related to claims arising against such parties pursuant to the terms of agreements entered into between such third parties and us in connection with such fundraising efforts. To the extent that such indemnification obligations apply to the lawsuits described in “Note 7. Commitments and Contingencies” in Part II, Item 8 of this Form 10-K, any associated expenses incurred are included within the related accrued litigation expense amounts. No additional liability associated with such indemnification agreements has been recorded at December 31, 2016.

ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Market Risk

Our exposure to market risk is confined to our cash, cash equivalents and our investments. The goals of our investment policy are preservation of capital, fulfillment of liquidity needs and fiduciary control of cash and cash equivalents and investments. We also seek to maximize income from our investments without assuming significant risk. To achieve our goals, we maintain a portfolio of cash equivalents and investments in a variety of securities of high credit quality. The securities in our investment portfolio are not leveraged, are classified as available for sale and are, due to their short-term nature, subject to minimal interest rate risk. We currently do not hedge interest rate exposure. Because of the short-term maturities of our investments, we do not believe that an increase in market rates would have any material negative impact on the value of our investment portfolio.

Foreign Exchange Risk

The majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, a portion of our operations consists of development and sales activities outside of the United States therefore we have foreign exchange exposures relating to non-U.S. dollar revenue, operating expense, accounts receivable, accounts payable and currency balances. Our primary exposure is with the Euro. A 10% strengthening of the U.S. dollar exchange rate against all currencies with which we have exposure, after taking into account offsetting positions at December 31, 2016 would have resulted in a \$0.6 million decrease in the carrying amounts of those net assets. Actual gains and losses in the future may differ materially from the hypothetical gains and losses discussed above based on changes in the timing and amount of foreign currency exchange rate movements and our actual exposure.

Our international operations are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign exchange rate volatility.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTAL DATA

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of Pacific Biosciences of California, Inc.

We have audited the accompanying consolidated balance sheets of Pacific Biosciences of California, Inc. as of December 31, 2016 and 2015, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pacific Biosciences of California, Inc. at December 31, 2016 and 2015, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Pacific Biosciences of California, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated March 6, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Redwood City, California

March 6, 2017

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Balance Sheets

(in thousands, except per share amounts)	December 31,	
	2016	2015
Assets		
Current assets		
Cash and cash equivalents	\$ 16,765	\$ 33,629
Investments	55,213	48,641
Accounts receivable	11,421	5,245
Inventory	15,634	10,955
Prepaid expenses and other current assets	9,978	12,071
Total current assets	109,011	110,541
Property and equipment, net	14,560	8,548
Long-term restricted cash	4,500	4,500
Other long-term assets	9,813	7,518
Total assets	\$ 137,884	\$ 131,107
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 8,359	\$ 4,749
Accrued expenses	16,604	15,551
Deferred service revenue, current	7,130	6,815
Deferred contractual revenue, current	—	10,822
Other liabilities, current	1,681	241
Total current liabilities	33,774	38,178
Deferred service revenue, non-current	1,297	1,143
Deferred contractual revenue, non-current	—	1,312
Other liabilities, non-current	1,683	1,386
Notes payable	16,106	14,948
Financing derivative	356	600
Total liabilities	53,216	57,567
Commitments and contingencies (Note 7)		
Stockholders' equity		
Preferred Stock, \$0.001 par value:		
Authorized 50,000 shares; No shares issued or outstanding	—	—
Common Stock, \$0.001 par value:		
Authorized 1,000,000 shares; Issued and outstanding 92,677 and 79,983 shares at December 31, 2016 and 2015, respectively	93	80
Additional paid-in-capital	872,114	786,636
Accumulated other comprehensive income (loss)	5	(7)

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Accumulated deficit	(787,544)	(713,169)
Total stockholders' equity	84,668	73,540
Total liabilities and stockholders' equity	\$ 137,884	\$ 131,107

See accompanying notes to the consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Operations and Comprehensive Loss

(in thousands, except per share amounts)	Years ended December 31,		
	2016	2015	2014
Revenue:			
Product revenue	\$ 64,609	\$ 37,502	\$ 35,299
Service and other revenue	13,971	10,896	8,511
Contractual revenue	12,134	44,384	16,784
Total revenue	90,714	92,782	60,594
Cost of Revenue:			
Cost of product revenue	34,512	30,704	29,626
Cost of service and other revenue	12,042	8,628	7,566
Total cost of revenue	46,554	39,332	37,192
Gross profit	44,160	53,450	23,402
Operating Expense:			
Research and development	67,617	60,440	48,230
Sales, general and administrative	47,787	45,187	38,026
Gain on lease amendments	—	(23,043)	—
Total operating expense	115,404	82,584	86,256
Operating loss	(71,244)	(29,134)	(62,854)
Interest expense	(3,234)	(2,926)	(2,828)
Other income (expense), net	103	364	(478)
Net loss	(74,375)	(31,696)	(66,160)
Other comprehensive loss:			
Unrealized gain (loss) on investments	12	(16)	(5)
Comprehensive loss	\$ (74,363)	\$ (31,712)	\$ (66,165)
Net loss per share:			
Basic and diluted net loss per share	\$ (0.83)	\$ (0.42)	\$ (0.94)
Shares used in computing basic and diluted net loss per share	89,148	75,614	70,475

See accompanying notes to the consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Stockholders' Equity

(in thousands)	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
Balance at December 31, 2013	66,275	\$ 66	\$ 684,413	\$ 14	\$ (615,313)	\$ 69,180
Net loss	—	—	—	—	(66,160)	(66,160)
Other comprehensive loss	—	—	—	(5)	—	(5)
Issuance of common stock in conjunction with equity plans	1,901	2	3,966	—	—	3,968
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	5,751	6	38,017	—	—	38,023
Stock-based compensation expense	—	—	9,943	—	—	9,943
Balance at December 31, 2014	73,927	74	736,339	9	(681,473)	54,949
Net loss	—	—	—	—	(31,696)	(31,696)
Other comprehensive loss	—	—	—	(16)	—	(16)
Issuance of common stock in conjunction with equity plans	1,981	2	7,361	—	—	7,363
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	4,075	4	29,096	—	—	29,100
Stock-based compensation expense	—	—	13,840	—	—	13,840
Balance at December 31, 2015	79,983	80	786,636	(7)	(713,169)	73,540
Net loss	—	—	—	—	(74,375)	(74,375)
Other comprehensive loss	—	—	—	12	—	12
Issuance of common stock in conjunction with equity plans	2,004	2	7,727	—	—	7,729
Issuance of common stock in conjunction with "at-the-market" offering, net of issuance costs	6,526	7	58,193	—	—	58,200
Issuance of common stock from exercise of warrant	4,164	4	(4)	—	—	—
Stock-based compensation expense	—	—	19,562	—	—	19,562
Balance at December 31, 2016	92,677	\$ 93	\$ 872,114	\$ 5	\$ (787,544)	\$ 84,668

See accompanying notes to the consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Consolidated Statements of Cash Flows

(in thousands)	Years Ended December 31,		
	2016	2015	2014
Cash flows from operating activities			
Net loss	\$ (74,375)	\$ (31,696)	\$ (66,160)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization	3,875	3,677	4,221
Amortization of debt discount and financing costs	1,158	957	793
Stock-based compensation	19,562	13,840	9,943
Non-cash portion of gain on lease amendments	—	(3,043)	—
Other items	(147)	(230)	507
Changes in assets and liabilities			
Accounts receivable	(6,176)	(1,738)	(660)
Inventory	(6,151)	(2,466)	(1,285)
Prepaid expenses and other assets	(202)	(17,889)	(224)
Accounts payable	3,402	(716)	3,891
Accrued expenses	1,053	5,732	3,536
Deferred service revenue	469	708	2,686
Deferred contractual revenue	(12,134)	(14,386)	(6,784)
Other liabilities	1,737	(639)	(1,932)
Net cash used in operating activities	(67,929)	(47,889)	(51,468)
Cash flows from investing activities			
Purchase of property and equipment	(8,207)	(3,009)	(1,609)
Proceeds from disposal of property and equipment	10	36	—
Long-term restricted cash	—	(4,500)	—
Purchase of investments	(95,848)	(84,579)	(126,413)
Sales of investments	23,285	8,317	—
Maturities of investments	65,896	92,341	147,586
Net cash provided by (used in) investing activities	(14,864)	8,606	19,564
Cash flows from financing activities			
Proceeds from issuance of common stock from equity plans	7,729	7,363	3,968
Proceeds from issuance of common stock from "at-the-market" offering, net of issuance costs	58,200	29,100	38,023
Net cash provided by financing activities	65,929	36,463	41,991
Net increase (decrease) in cash and cash equivalents	(16,864)	(2,820)	10,087
Cash and cash equivalents at beginning of period	33,629	36,449	26,362
Cash and cash equivalents at end of period	\$ 16,765	\$ 33,629	\$ 36,449
Supplemental disclosure of cash flow information			
Interest paid	\$ 1,799	\$ 1,794	\$ 1,794

Supplemental disclosure of non-cash investing and financing activities			
Inventory transferred to property and equipment	1,282	2,846	—

See accompanying notes to the consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Notes to Consolidated Financial Statements

NOTE 1. OVERVIEW

We design, develop and manufacture sequencing systems to help scientists resolve genetically complex problems. Based on our novel Single Molecule, Real-Time (SMRT®) Sequencing technology, our products enable: de novo genome assembly to finish genomes in order to more fully identify, annotate and decipher genomic structures; full-length transcript analysis to improve annotations in reference genomes, characterize alternatively spliced isoforms and find novel genes; targeted sequencing to more comprehensively characterize genetic variations; and DNA base modification identification to help characterize epigenetic regulation and DNA damage. Our technology combines very high consensus accuracy and long read lengths with the ability to detect real-time kinetic information.

In September 2015, we announced that we had launched a new nucleic acid sequencing platform, the PacBio Sequel™ System (the “Sequel System”), which will provide higher throughput, more scalability, a reduced footprint and lower sequencing project costs compared to the PacBio® RS II System, while maintaining the existing benefits of our SMRT Technology.

The names “Pacific Biosciences,” “PacBio,” “SMRT,” “SMRTbell,” “Sequel” and our logo are our trademarks.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Consolidation

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States, or U.S. GAAP, as set forth in the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC. The consolidated financial statements include the accounts of Pacific Biosciences and our wholly owned subsidiaries. All intercompany transactions and balances have been eliminated. Translation adjustments resulting from translating foreign subsidiaries’ results of operations and assets and liabilities into U.S. dollars are immaterial for all periods presented.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes to the financial statements. Our estimates include, but are not limited to, the valuation of inventory, revenue valuation, the valuation of a financing derivative and long-term notes, the valuation and recognition of share-based compensation, the delivery period for collaboration agreements, the useful lives assigned to long-lived assets, and the computation provisions for income taxes. Actual results could differ materially from these estimates.

During 2013, we entered into a Development, Commercialization and License Agreement (the “Roche Agreement”) with F. Hoffman-La Roche Ltd (“Roche”) and received a non-refundable up-front payment of \$35.0 million. Revenue for the year ended December 31, 2014 included four quarterly periods of amortization of \$1.7 million from the non-refundable up-front payment of \$35.0 million. During the first quarter of 2015, we revised the estimated period

over which the delivery of elements pursuant to the Roche Agreement was expected to occur due to an increased level of certainty regarding the development period. As a result, we began, on a prospective basis, recognizing the remaining deferred contractual revenue associated with the upfront payment received under the Roche Agreement over the revised estimated remaining development period. For the year ended December 31, 2015, this change in estimate increased contractual revenue by \$7.6 million, and decreased our basic and diluted net loss per share by \$0.10. Quarterly amortization of \$3.6 million was recognized as contractual revenue for each of the four quarters of 2015 and for each of the first three quarters of 2016. In December 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. Upon such notice in December 2016, no further participation on the joint steering committee was deemed necessary; as such, we recognized the entire then-remaining unamortized deferred revenue of \$1.3 million as contractual revenue in the fourth quarter of 2016.

Fair Value of Financial Instruments

The carrying amount of our accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses and other liabilities, current, approximate fair value due to their short maturities. The carrying value of our other liabilities, non-current, approximates fair value due to the time to maturity and prevailing market rates.

The fair value hierarchy established under U.S. GAAP requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are as follows:

- 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 in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities 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; and
- 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 consider an active market as one in which transactions for the asset or liability occurs with sufficient frequency and volume to provide pricing information on an ongoing basis. Conversely, we view an inactive market as one in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers. Where appropriate, our non-performance risk, or that of our counterparty, is considered in determining the fair values of liabilities and assets, respectively.

We classify our cash deposits and money market funds within Level 1 of the fair value hierarchy because they are valued using bank balances or quoted market prices. We classify our investments as Level 2 instruments based on market pricing and other observable inputs. We did not classify any of our investments within Level 3 of the fair value hierarchy.

Assets and liabilities measured at fair value are classified in their entirety based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the entire fair value measurement requires management to make judgments and consider factors specific to the asset or liability.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table sets forth the fair value of our financial assets and liabilities that were measured on a recurring basis as of December 31, 2016 and 2015, respectively (in thousands):

(in thousands)	December 31, 2016				December 31, 2015			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets								
Cash and cash equivalents:								
Cash and money market funds	\$ 14,516	\$ —	\$ —	\$ 14,516	\$ 22,034	\$ —	\$ —	\$ 22,034
Commercial paper	—	2,249	—	2,249	—	8,595	—	8,595
US government & agency securities	—	—	—	—	—	3,000	—	3,000
Total cash and cash equivalents	14,516	2,249	—	16,765	22,034	11,595	—	33,629
Investments:								
Commercial paper	—	23,583	—	23,583	—	15,903	—	15,903
Corporate debt securities	—	10,739	—	10,739	—	1,265	—	1,265
US government & agency securities	—	20,579	—	20,579	—	28,136	—	28,136

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Asset backed securities	—	312	—	312	—	3,337	—	3,337
Total investments	—	55,213	—	55,213	—	48,641	—	48,641
Long-term restricted cash:								
Cash	4,500	—	—	4,500	4,500	—	—	4,500
Total assets measured at fair value	\$ 19,016	\$ 57,462	\$ —	\$ 76,478	\$ 26,534	\$ 60,236	\$ —	\$ 86,770
Liabilities								
Financing derivative	\$ —	\$ —	\$ 356	\$ 356	\$ —	\$ —	\$ 600	\$ 600
Total liabilities measured at fair value	\$ —	\$ —	\$ 356	\$ 356	\$ —	\$ —	\$ 600	\$ 600

The estimated fair value of the Financing Derivative liability (as defined in “Note 6. Notes Payable”) was determined using Level 3 inputs, or significant unobservable inputs. Refer to “Note 6. Notes Payable” for a detailed description and valuation approach. Changes to the estimated fair value of the Financing Derivative are recorded in “Other income (expense), net” in the consolidated statements of operations and comprehensive loss.

The following table provides the changes in the fair value of the Financial Derivative for the year ended December 31, 2016 and 2015 (in thousands), respectively:

Financing Derivative	Amount
Balance as of December 31, 2014	\$ 944
Gain on change in fair value of Financing Derivative	(344)
Balance as of December 31, 2015	600
Gain on change in fair value of Financing Derivative	(244)
Balance as of December 31, 2016	\$ 356

For the year ended December 31, 2016, there were no transfers between Level 1, Level 2, or Level 3 assets or liabilities reported at fair value on a recurring basis and our valuation techniques did not change compared to the prior year.

Financial Assets and Liabilities Not Measured at Fair Value on a Recurring Basis

The carrying amount of our accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses and other current liabilities approximate fair value due to their short maturities. The carrying value of our facility financing obligation approximates fair value due to the time to maturity and prevailing market rates.

We determined the fair value of the Notes (as defined in “Note 6. Notes Payable”) from the debt facility we entered into during the first quarter of 2013 using Level 3 inputs, or significant unobservable inputs. The value of the Notes was determined by comparing the difference between the fair value of the Notes with and without the Financing Derivative by calculating the respective present values from future cash flows using a 10.6% and 13.5% weighted average market yield at December 31, 2016 and December 31, 2015, respectively. Refer to “Note 6. Notes Payable” for additional details regarding the Notes. The estimated fair value and carrying value of the Notes are as follows (in thousands):

	December 31, 2016		December 31, 2015	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Long-term notes payable	\$ 19,788	\$ 16,106	\$ 18,037	\$ 14,948

Cash and Cash Equivalents

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Investments

We have designated all investments as available-for-sale and therefore, such investments are reported at fair value, with unrealized gains and losses recognized in accumulated other comprehensive income (loss) (“OCI”) in stockholders’ equity. The cost of marketable securities is adjusted for the amortization of premiums and discounts to expected maturity. Premium and discount amortization is included in other income, net. Realized gains and losses, as well as interest income, on available-for-sale securities are also included in other income, net. The cost of securities sold is based on the specific identification method. We include all of our available-for-sale securities in current assets.

All of our investments are subject to a periodic impairment review. We recognize an impairment charge when a decline in the fair value of our investments below the cost basis is judged to be other-than-temporary. Factors considered in determining whether a loss is temporary include the length of time and extent to which the investments fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, extent of the loss related to credit of the issuer, the expected cash flows from the security, our intent to sell the security and whether or not we will be required to sell the security before the recovery of its amortized cost. During the years ended December 31, 2016, 2015 and 2014, we did not recognize any impairment charges on our investments as it is more likely than not that we will recover their amortized cost basis upon sale or maturity.

Concentration and Other Risks

The counterparties to the agreements relating to our investment securities consist of various major corporations, financial institutions, municipalities and government agencies of high credit standing. Our accounts receivable are derived from net revenue to customers and distributors located in the United States and other countries. We perform credit evaluations of our customers’ financial condition and, generally, require no collateral from our customers. We regularly review our accounts receivable including consideration of factors such as historical experience, credit quality, the age of the accounts receivable balances and current economic conditions that may affect a customer’s ability to pay. We have not experienced any significant credit losses to date.

For the years ended December 31, 2016, 2015 and 2014, excluding contractual revenue, no single end customer accounted for more than 10% of our total revenue.

As of December 31, 2016 and 2015, 84% and 64%, respectively, of our accounts receivable were from domestic customers. As of December 31, 2016, no single customer represented more than 10% of our net accounts receivable. As of December 31, 2015, four customers each represented more than 10% of our net accounts receivable.

We currently purchase several key parts and components used in the manufacture of our products from a limited number of suppliers. Generally we have been able to obtain an adequate supply of such parts and components. However, an extended interruption in the supply of parts and components currently obtained from our suppliers could adversely affect our business and consolidated financial statements.

Inventory

Inventory is valued at the lower of standard cost, which approximates actual cost, or market. Cost is determined using the first-in, first-out (“FIFO”) method. Adjustments to reduce the cost of inventory to its net realizable value, if required, are made for estimated excess or obsolete balances.

Property and Equipment, Net

Property and equipment are stated at cost, net of accumulated depreciation and any impairment charges. Depreciation is computed using the straight-line method over the estimated useful life of the asset, generally two to three years for computer equipment, three to five years for software, three to seven years for furniture and fixtures, three years for lab equipment and 30 years for buildings. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life of the related asset. Major improvements are capitalized, while maintenance and repairs are expensed as incurred.

In connection with build-to-suit lease arrangements that we account for as if we own the facility, we record the facility at the fair value at the date construction commences, prior to significant renovations, plus the costs of the renovations. We determined the fair value of such facilities prior to renovation based on several factors, including an appraisal conducted by an independent licensed appraiser.

Long-term Restricted Cash

Long-term restricted cash as of December 31, 2016 was comprised of \$4.5 million pledged as collateral for an irrevocable letter of credit for our O’Brien Lease entered into in July 2015. The letter of credit currently expires in more than one year. The time deposit securing the letter of credit was classified as Long-term restricted cash in the accompanying consolidated balance sheets as of December 31, 2016.

Impairment of Long-Lived Assets

We periodically review property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset is impaired or the estimated useful lives are no longer appropriate. Fair value is estimated based on discounted future cash flows. If indicators of impairment exist and the undiscounted projected cash

flows associated with such assets are less than the carrying amount of the asset, an impairment loss is recorded to write the asset down to its estimated fair value. To date, we have not recorded any impairment charges.

Revenue Recognition

Our revenue is generated primarily from the sale of products and services, in addition to revenue from collaboration agreements. Product revenue consists of sales of our instruments and related consumables; Service and other revenue primarily consist of revenue earned from product maintenance agreements, instrument lease agreements and grant revenue. Contractual revenue relates to revenue recognized from the collaboration agreement under which we received an upfront fee and may receive contingent milestone payments. Our deliverables under the arrangement include licenses to intellectual property rights and research and development services.

We recognize revenue 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. For instances where final acceptance of the product or system is required, revenue is deferred until all acceptance criteria have been met. Revenue for product sales is generally recognized upon customer acceptance. For certain qualified distributors revenue is recognized based upon shipment terms. Revenue for product maintenance agreements is recognized when earned, which is generally ratably over the service period. In order to assess whether the price is fixed or determinable, we evaluate whether refund rights exist. If refund rights exist or payment terms are based on future performance, we defer revenue recognition until the price becomes fixed or determinable. We assess collectability based on a number of factors, including customer creditworthiness. If we determine that collection of amounts due is not reasonably assured, revenue recognition is deferred until receipt of payment.

We regularly enter into arrangements, comprised of one or more contracts, from which revenue is derived from multiple deliverables including a mix of products and or services. Revenue recognition for contracts with multiple deliverables is based on the individual units of accounting determined to exist in the contract. A delivered item is considered a separate unit of accounting when (i) the delivered item has value to the customer on a stand-alone basis; and (ii) if a general right of return exists, the delivery or performance of an undelivered item is considered probable and under our control. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. Our revenue arrangements generally do not have a general right of return. When a deliverable does not meet the criteria to be considered a separate unit of accounting, we group it with other deliverables that, when combined, meet the criteria, and the appropriate allocation of arrangement consideration and revenue recognition is determined. Consideration is allocated at the inception of the contract to all deliverables based on their relative selling price. In order to determine the relative selling price of a deliverable, we apply, in order, vendor-specific objective evidence (“VSOE”); third-party evidence if VSOE is not available; and lastly our best estimate of selling price for the deliverable if neither VSOE nor third-party evidence is available.

In order to establish VSOE, we must regularly sell the product or service on a standalone basis with a substantial majority of sales priced within a relatively narrow range. If an insufficient number of standalone sales exist and VSOE cannot be determined, we then consider whether third party evidence can be used to establish selling price. Due to the lack of similar products and services sold by other companies within our industry, we have not established selling price using third-party evidence. If neither VSOE nor third party evidence of selling price exists, we determine our best estimate of selling price using a combination of prices set by our pricing committee adjusted for applicable discounts and customer orders received to date.

For our collaboration agreement, the process for determining estimates of selling prices of the identifiable deliverables involves significant judgments and estimates to be made by management. Our process considers multiple factors such as estimated headcount, annual research and development budget, estimated length of the research and development period and estimated transfer price on cost, which may vary over time, depending upon the circumstances, and are specific to each deliverable.

Deferred service revenue primarily represents product maintenance agreement revenue that is expected to be recognized over the related service period, generally one to three years.

For instrument lease agreements we entered into with our customers so far, they are classified as operating-type leases and revenue from these leases is recognized on a straight-line basis over the respective lease term, once the lessee takes (or has the right to take) control/possession of the property under the lease. Effectively, this occurs once installation is complete and acceptance has been obtained.

We recognize milestone revenues as they become earned. Based on Accounting Standards Codification, or ASC, Topic 605-28, Revenue Recognition — Milestone Method, we evaluate contingent milestones at inception of the agreement, and recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is considered substantive in its entirety. Milestones are considered substantive if the consideration earned from the achievement of the milestone (i) is consistent with performance required to achieve the milestone or the increase in value to the delivered item, (ii) relates solely to past performance and (iii) is reasonable relative to all of the other deliverables and payments within the arrangement.

Cost of Revenue

Cost of revenue reflects the direct cost of product components, third-party manufacturing services and our internal manufacturing overhead and customer service infrastructure costs incurred to produce, deliver, maintain and support our instruments, consumables, and services. There are no incremental costs associated with our contractual revenue; all product development costs are reflected in research and development expense.

Manufacturing overhead is predominantly comprised of labor and facility costs. We determine and capitalize manufacturing overhead into inventory based on a standard cost model that approximates actual costs. Prior to achieving manufacturing volumes that correlated with our estimated normal capacity (the production levels expected to be achieved over a number of periods under normal circumstances with available resources), we based our capitalized overhead relative to our normal capacity. Prior to achieving normal capacity, excess manufacturing resources were engaged in research and development activities, including; next generation products, internal use research products, and general support activities. As such, manufacturing costs in excess of amounts reflected in inventory were expensed as a component of research and development expense.

Service costs include the direct costs of components used in support, repair and maintenance of customer instruments as well as the cost of personnel, materials, shipping and support infrastructure necessary to support the installed customer base.

Research and Development

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Research and development expense consists primarily of expenses for personnel engaged in the development of our SMRT technology, the design and development of our future products and current product enhancements. These expenses also include prototype-related expenditures, development equipment and supplies, facilities costs and other related overhead. We expense research and development costs during the period in which the costs are incurred. However, we defer and capitalize non-refundable advance payments made for research and development activities until the related goods are received or the related services are rendered.

Leases

We categorize leases at their inception as either operating or capital leases. On certain of our lease agreements, we may receive tenant improvement allowances, rent holidays and other incentives. Rent expense is recorded on a straight-line basis over the term of the lease. The difference between rent expense recognized and amounts paid under the lease agreement is recorded as deferred rent in the balance sheets. Leasehold improvements are capitalized at cost and depreciated over the shorter of their expected useful life or the life of the lease. Tenant improvements afforded to us by landlord incentives are recorded as leasehold improvement assets with corresponding deferred rent liabilities.

For build-to-suit lease arrangements, we evaluate the extent of our financial and operational involvement in the tenant improvements to determine whether we are considered the owner of the construction project under U.S. GAAP. When we are considered the owner of a project, we record the shell of the facility at its fair value at the date construction commences with a corresponding facility financing obligation. Improvements to the facility during the construction project are capitalized and, to the extent funded by lessor afforded incentives, with corresponding increases to the facility financing obligation. Payments we make under leases in which we are considered the owner of the facility are allocated to land rental expense, based on the relative values of the land and building at the commencement of construction, reductions of the facility financing obligation and interest expense recognized on the outstanding obligation. To the extent gross future payments do not equal the recorded liability, the liability is settled upon return of the facility to the lessor. Any difference between the book value of the assets and remaining facility obligation are recorded in other expense, net. For existing arrangements, the differences are expected to be immaterial.

Income Taxes

We account for income taxes under the asset and liability method, which requires, among other things, that deferred income taxes be provided for temporary differences between the tax basis of our assets and liabilities and the amounts reported in the financial statements. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating losses and research and development credit carryforwards. A full valuation allowance is provided against our net deferred tax assets as it is more likely than not that the deferred tax assets will not be fully realized.

We review our positions taken relative to income taxes. To the extent our tax positions are more likely than not to result in the payout of additional taxes, we accrue the estimated amount of tax for such uncertain positions.

Stock-based Compensation

Stock-based compensation expense for all stock-based compensation awards is based on the grant date fair value estimated using the Black-Scholes option pricing model. We have limited historical information available to support

the underlying estimates of certain assumptions required to value stock options. The expected term of options is estimated based on the simplified method. We do not have sufficient trading history to solely rely on the volatility of our own common stock for establishing expected volatility. Therefore, we based our expected volatility on the historical stock volatilities of our common stock as well as several comparable publicly listed companies over a period equal to the expected term of the options. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the stock option. We estimate our forfeiture rate based on an analysis of our actual forfeitures and will continue to evaluate the adequacy of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover behavior and other factors. The impact from a forfeiture rate adjustment will be recognized in full in the period of adjustment, and if the actual number of future forfeitures differs from that which was estimated, we may be required to record adjustments to stock-based compensation expense in future periods. We recognize compensation expense on a straight-line basis over the requisite service period. We elected to use the simplified method to calculate the beginning pool of excess tax benefits.

Other Comprehensive Income (loss)

Other comprehensive income (loss) is comprised of unrealized gains (losses) on our investment securities.

Recent Accounting Pronouncements

Recently Adopted Accounting Standards

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In July 2015, the FASB issued Accounting Standards Update (“ASU”) No. 2015-11, Simplifying the Measurement of Inventory, which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost and net realizable value test. ASU 2015-11 is effective for annual report periods beginning after December 15, 2016 and is effective for us in the first quarter of 2017. We have elected to early adopt ASU 2015-11 effective beginning with the three-month period ended March 31, 2016, as permitted by the standard. The early adoption of this update did not have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements – Going Concern Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern, which requires management to evaluate whether there are conditions or events that raise substantial doubt about an entity’s ability to continue as a going concern and to provide disclosures when certain criteria are met. The guidance is effective for annual periods beginning after December 15, 2016 and interim reporting periods starting in the first quarter of 2017. We adopted this standard as of December 31, 2016.

Recently Issued Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which amends the current stock compensation guidance. The amendments simplify the accounting for the taxes related to stock based compensation, including adjustments to how excess tax benefits and a company's payments for tax withholdings should be classified. Furthermore, the amendments allow the entities to make an accounting policy election to either estimate forfeitures or recognize forfeitures as they occur. If an election is made, the change to recognize forfeitures as they occur must be adopted using a modified retrospective approach with a cumulative effect adjustment recorded to opening retained earnings. The standard is effective for fiscal periods beginning after December 15, 2016, with early adoption permitted. We are currently evaluating which forfeiture method to use. In either scenario it will not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases. The guidance in ASU 2016-02 supersedes the lease recognition requirements in ASC Topic 840, Leases. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease for both financing and operating leases, along with additional qualitative and quantitative disclosures. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or the cumulative effect transition method. ASU 2014-09 is effective for periods beginning after December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of 2018. We are currently evaluating the new guidance to determine the impact it may have on our consolidated financial statements.

While we are continuing to assess all potential impacts of the new accounting standard, we currently believe the most significant impact relates to our accounting for incremental cost of obtaining a contract with a customer (i.e. sales commission). Under current GAAP, the cost incurred to obtain a contract is recognized in the period the expense is incurred while under the new standard, the incremental costs to obtain the contract will be allocated to the performance obligations using the relative fair value of these obligations, recognized as an asset and amortized over

the useful life of that asset. We are still in the process of evaluating the impact of this new standard on these arrangements. Due to the complexity of certain of our contracts, the actual revenue recognition treatment required under the new standard for these arrangements may be dependent on contract-specific terms and vary in some instances.

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NOTE 3. CONTRACTUAL REVENUE

In September 2013, we entered into the “Roche Agreement” with Roche, pursuant to which we accounted for, and recognized as revenue, the up-front payment received thereunder using the proportional performance method over the periods in which the delivery of elements pursuant to the Roche Agreement occurs. We recognized revenue under the Roche Agreement using a straight-line convention over the service periods of the deliverables as this method approximated our performance of services pursuant to the Roche Agreement. Out of the \$35.0 million upfront cash payment received, quarterly amortization of \$1.7 million was recognized as contractual revenue from the fourth quarter of 2013 to the fourth quarter of 2014. Beginning in the three-month period ended March 31, 2015, we revised the estimated development period related to our contractual revenue amortization based on increasing certainty of the development time on a prospective approach and quarterly amortization of \$3.6 million was recognized as contractual revenue for each of the four quarters of 2015 and for each of the first three quarters of 2016. As of September 30, 2016, the total deferred contractual revenue balance was \$1.3 million, relating to the amount allocated to the deliverable of our participation on the joint steering committee. In December 2016, we received notice from Roche that Roche had elected to terminate the Roche Agreement for convenience and the termination became effective February 10, 2017, which was 60 days after the date of the notice in accordance with the terms of the Roche Agreement. Upon such notice in December 2016, no further participation on the joint steering committee was deemed necessary; as such, we recognized the entire remaining unamortized deferred revenue of \$1.3 million as contractual revenue in the fourth quarter of 2016. As a result of Roche’s termination of the Roche Agreement, it may be more difficult for us to successfully market, sell and commercialize our products into the markets that Roche would have addressed under the Roche Agreement.

Further, the Roche Agreement provided for additional payments totaling \$40.0 million upon the achievement of certain development milestones, all of which have previously been received and recognized as revenue. Consideration from development milestones is recognized in the period in which a milestone is achieved only if the milestone is considered substantive in its entirety. We achieved the first development milestone under the Roche Agreement and recognized the related \$10.0 million as contractual revenue during the year ended December 31, 2014. We achieved the second and the third (final) development milestones under the Roche Agreement and recognized the related \$10.0 million and \$20.0 million as contractual revenue during the three-month periods ended June 30, 2015 and December 31, 2015, respectively. There are no other milestones remaining to be achieved.

NOTE 4. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The following table summarizes our cash, cash equivalents and investments as of December 31, 2016 and December 31, 2015 (in thousands):

	As of December 31, 2016			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				
Cash and money market funds	\$ 14,516	\$ —	\$ —	\$ 14,516
Commercial paper	2,249	—	—	2,249
Total cash and cash equivalents	16,765	—	—	16,765
Investments:				
Commercial paper	23,581	5	(3)	23,583
Corporate debt securities	10,741	1	(3)	10,739
Asset backed securities	312	—	—	312
US government & agency securities	20,574	7	(2)	20,579
Total investments	55,208	13	(8)	55,213
Total cash, cash equivalents and investments	\$ 71,973	\$ 13	\$ (8)	\$ 71,978
Long-term restricted cash:				
Cash	\$ 4,500	\$ —	\$ —	\$ 4,500

	As of December 31, 2015			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				
Cash and money market funds	\$ 22,034	\$ —	\$ —	\$ 22,034
Commercial paper	8,595	—	—	8,595
US government & agency securities	3,000	—	—	3,000
Total cash and cash equivalents	33,629	—	—	33,629
Investments:				
Commercial paper	15,903	2	(2)	15,903
Corporate debt securities	1,266	—	(1)	1,265
Asset backed securities	3,337	—	—	3,337
US government & agency securities	28,142	4	(10)	28,136
Total investments	48,648	6	(13)	48,641
Total cash, cash equivalents and investments	\$ 82,277	\$ 6	\$ (13)	\$ 82,270
Long-term restricted cash:				
Cash	\$ 4,500	\$ —	\$ —	\$ 4,500

The following table summarizes the contractual maturities of our cash equivalents and available-for-sale investments, excluding money market funds, as of December 31, 2016:

(in thousands)	Fair Value
Due in one year or less	\$ 57,462

Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without call or prepayment penalties.

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NOTE 5. BALANCE SHEET COMPONENTS

Inventory

As of December 31, 2016 and 2015, our inventory consisted of the following components:

(in thousands)	December 31,	
	2016	2015
Purchased materials	\$ 4,817	\$ 4,041
Work in process	7,287	3,576
Finished goods	3,530	3,338
Inventory	\$ 15,634	\$ 10,955

Prepaid Expenses and Other Current Assets

As of December 31, 2016 and 2015, our prepaid expenses and other current assets consisted of the following components:

(in thousands)	December 31,	
	2016	2015
Receivable from Existing Landlord	\$ 5,000	\$ 10,000
Rent deposits for O'Brien building	2,160	—
Prepaid expenses	2,342	1,330
Other current assets	476	741
Prepaid expenses and other current assets	\$ 9,978	\$ 12,071

Other Long-term Assets

As of December 31, 2016 and 2015, our other long-term assets consisted of the following components:

December 31,

(in thousands)	2016	2015
Receivable from Existing Landlord	\$ —	\$ 5,000
Rent deposits and tenant improvements for O'Brien building	9,641	2,160
Other	172	358
Other long-term assets	\$ 9,813	\$ 7,518

Receivable from existing landlord of \$10.0 million as of December 31, 2015 was part of the \$15.0 million of future payments receivable from our existing landlord for our Menlo Park facility real property leases, as described in further details in "Note 7. Commitments and Contingencies." Of the amount receivable, \$10.0 million was recorded as a short-term receivable in "Prepaid and Other Current Assets" and the final \$5.0 million was recorded in "Other Long-term Assets" as of December 31, 2015, based on the expected timing of receipt of the payment. During the year ended December 31, 2016, two \$5.0 million Landlord Payments were received in February 2016 and in August 2016 and at December 31, 2016, the final \$5.0 million was recorded in "Prepaid Expenses and Other Current Assets" in the consolidated balance sheets.

In addition, rent deposits and tenant improvements for our 1305 O'Brien building of \$9.6 million and \$2.2 million were recorded, respectively, in "Other long-term assets" in the consolidated balance sheets at December 31, 2016 and 2015.

In January 2017, we entered into a Third Lease Amendment Agreement with the Existing Landlord that increased the amount of the payments receivable from the Existing Landlord by \$65,000.

Property and Equipment, Net

As of December 31, 2016 and 2015, our property and equipment, net, consisted of the following components:

(in thousands)	December 31,	
	2016	2015
Building	\$ 1,160	\$ 1,160
Laboratory equipment and machinery	23,337	20,358
Leasehold improvements	8,138	8,348
Computer equipment	7,170	6,781
Software	5,189	4,798
Furniture and fixtures	823	968
Construction in progress	5,772	—
	51,589	42,413
Less: Accumulated depreciation	(37,029)	(33,865)
Property and equipment, net	\$ 14,560	\$ 8,548

At December 31, 2016, out of the construction-in-progress balance of \$5.8 million, approximately \$5.2 million related to 1305 O'Brien building purchases.

Depreciation expense during the years ended December 31, 2016, 2015 and 2014 was \$3.9 million, \$3.7 million and \$4.2 million, respectively.

Accrued Expenses

As of December 31, 2016 and 2015, our accrued expenses consisted of the following components:

(in thousands)	December 31,	
	2016	2015
Salaries and benefits	\$ 8,562	\$ 8,129
Accrued license and development services	5,411	5,459
Inventory accrual, professional services, accrued interest and other	2,631	1,963
Accrued expenses	\$ 16,604	\$ 15,551

NOTE 6. NOTES PAYABLE

Facility Agreement

Pursuant to a Facility Agreement (the “Facility Agreement”) we entered into with entities affiliated with Deerfield Management Company, L.P. (collectively, “Deerfield”) during February 2013, we issued promissory notes in the aggregate principal amount of \$20.5 million (the “Notes”). The Notes bear simple interest at a rate of 8.75% per annum, payable quarterly in arrears commencing on April 1, 2013.

In connection with the execution of the Facility Agreement, we issued warrants to purchase an aggregate of 5.5 million shares of common stock immediately exercisable at an exercise price per share initially equal to \$2.63 (the “Warrants”). During the year ended December 31, 2016, warrants to purchase 5.5 million shares of common stock were net exercised, resulting in the issuance of approximately 4.2 million shares. The cashless net exercises of the warrants did not result in any additional funds being collected by us. As of December 31, 2016, no warrants remained outstanding.

In addition, the Facility Agreement requires us to maintain consolidated cash and cash equivalents on the last day of each calendar quarter of not less than \$2.0 million. As security for our repayment of our obligations under the Facility Agreement, we granted to Deerfield a security interest in substantially all of our property.

The Facility Agreement has a maximum term of seven years from inception. Subsequent to the date of the Facility Agreement, at the election of the holders of Notes representing a majority of the aggregate principal amount of the outstanding Notes, the Notes holders may elect to receive 25% of the net proceeds from any financing that includes an equity component, including without limitation, the sale or issuance of our common stock, options, warrants or other securities convertible or exchangeable for shares of our common stock, as payment of the Notes. This right is subject to certain exceptions set forth in the Facility Agreement. The Notes holders have the option to require us to repay the Notes if we complete a Major Transaction (as defined in the Facility Agreement), including a change of control or a sale of all or substantially all of our assets. Additionally, the principal balance of the Facility Agreement may become immediately due and payable upon an Event of Default (as defined in the Facility Agreement), in which case the Notes holders would have the right to require us to repay 100% of the principal amount of the loan, plus any accrued and unpaid interest thereon. The Facility Agreement does not provide for a prepayment of the Notes at our option.

Financing Derivative

A number of features embedded in the Notes to the Facility Agreement required accounting for as a derivative, including the indemnification of certain withholding taxes and the acceleration of debt upon (i) a qualified financing, (ii) an event of default, (iii) a Major Transaction, and (iv) the exercise of the warrant via offset to debt principal. These features represent a single derivative (the "Financing Derivative") that was bifurcated from the debt instrument and accounted for as a liability at fair value, with changes in fair value between reporting periods recorded in other income (expense), net.

The estimated fair value of the Financing Derivative was determined by comparing the difference between the fair value of the Notes with and without the Financing Derivative by calculating the respective present values from future cash flows using a 10.6% and 13.5% weighted average market yield at December 31, 2016 and December 31, 2015, respectively. The estimated fair value of the Financing Derivative as of December 31, 2016 and December 31, 2015 was \$0.4 million and \$0.6 million, respectively.

Notes

We initially recorded the Notes and Warrants at \$14.1 million and \$6.4 million, respectively, based upon the relative fair value allocation of the \$20.5 million of proceeds. The carrying value of the Notes at the inception of the debt was \$12.8 million, resulting in an original issue discount of \$7.7 million. As of December 31, 2016 and 2015, debt discount of \$4.3 million and \$5.4 million, respectively, remained to be amortized through February 2020, the maturity of the Notes.

As of December 31, 2016, debt payments, which include interest and principal, are as follows (in thousands):

2017	\$ 1,794
2018	5,375
2019	2,816
2020	15,852
Total remaining payments	25,837
Less: interest and discounts	(9,731)

Notes payable	16,106
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NOTE 7. COMMITMENTS AND CONTINGENCIES

Leases

In December 2009, we entered into a lease agreement for a manufacturing and office facility in Menlo Park. In order for the facility to meet our needs and operating requirements, substantial tenant improvements, including improvements to the structural elements and principal operating systems of the facility, were necessary. The lessor provided a tenant improvement allowance of \$1.8 million to apply towards the necessary improvements and we remained obligated for additional amounts over the afforded allowance. Due to our involvement in and the nature of the renovations made to the facility and our obligations to fund the costs of renovations exceeding the incentives afforded to us, we account for the facility as if we are the owner. Accordingly, we recorded \$3.0 million of building and leasehold improvement assets, reflecting the \$1.2 million fair value of the facility prior to commencing renovations and the \$1.8 million of landlord incentives within property and equipment, net and a corresponding liability recorded to facility financing obligation.

As a result of the lease amendment agreement described below, future rent expense associated with our existing Menlo Park facility leases was reduced to zero. The remaining long-term facility financing obligations associated with these leases, presented as “Other liabilities, non-current” on the consolidated balance sheets at December 31, 2016 and December 31, 2015, were \$1.7 million and \$1.4 million, respectively.

Lease Amendment Agreement

On July 23, 2015, we entered into a Lease Amendment Agreement (the “Lease Amendment Agreement”) with Peninsula Innovation Partners, LLC (the “Existing Landlord”), which amends the terms and conditions of certain of our existing Menlo Park facility real property leases. The Lease Amendment Agreement provides for, among other things, amendments of the term for certain of the leases with the Existing Landlord, the termination of all renewal, expansion and extension rights contained in any of the existing leases with the Existing Landlord (including our options to extend the terms for certain of the existing leases for two consecutive five-year periods), as well as rent abatement for a specified period of time. As consideration for our agreement to amend the existing leases pursuant to the Lease Amendment Agreement, and subject to the terms and conditions contained therein, we became eligible to receive up to four payments of \$5.0 million each from the Existing Landlord over time (the “Landlord Payments”), and rent abatement for the remainder of the lease. In the event that we breach any of the leases and fail to cure such breach within the time permitted, the Existing Landlord would have no obligation to make the final \$5.0 million payment. On September 1, 2015, the permit process related to an architectural approval and a change of use permit with respect to our new premises at 1305 O’Brien Drive (formerly 1315 O’Brien Drive), Menlo Park, California (the “O’Brien Premises”) was completed, which satisfied the contingencies under the Lease Amendment Agreement. As a result, we recorded \$23.0 million in “Gain on lease amendments” in the consolidated statements of operations and comprehensive loss for the three-month period ended September 30, 2015, reflecting that our rent payments were reduced to zero for the remaining term of our existing Menlo Park facility real property leases, and the aggregate of \$20.0 million in Landlord Payments became receivable and any associated financing obligation was revalued. Of the \$20.0 million remaining Landlord Payments, the first \$5.0 million Landlord Payment was received in September 2015, the second \$5.0 million Landlord Payment was received in February 2016 and the third \$5.0 million Landlord Payment was received in August 2016.

In June 2016, we entered into a Second Lease Amendment Agreement with the Existing Landlord that modified the payment schedule for the final \$5.0 million. At December 31, 2016, the final \$5.0 million was recorded in “Prepaid Expenses and Other Current Assets” in the consolidated balance sheets. We do not believe that there are any remaining performance obligations relating to the remaining Landlord Payments. In January 2017, we entered into a Third Lease Amendment Agreement with the Existing Landlord that increased the amount of the payments receivable from the Existing Landlord by \$65,000. In February 2017, we received \$1,045,000 out of the total receivable of \$5,065,000 from the Existing Landlord.

O’Brien Lease Agreement

On July 22, 2015, we entered into a new lease agreement (the “O’Brien Lease”) with respect to the O’Brien Premises. The term of the O’Brien Lease is one hundred thirty-two (132) months, commencing on the date that is the later of April 15, 2016 or the date on which the O’Brien Premises landlord has substantially completed certain shell improvements and tenant improvements. In December 2016, we entered into an amendment to the O’Brien Lease which defined the commencement date of the lease to be October 25, 2016, notwithstanding that such substantial completion date had not yet occurred. We did not have control of the building until after December 31, 2016. Base monthly rent will be abated for the first six (6) months of the lease term and thereafter will be \$540,000 per month during the first year of the lease term, with specified annual increases thereafter until reaching \$711,000 per month during the last twelve (12) months of the lease term. We were required to pay \$2,160,000 in prepaid rent which will be applied to the monthly rent installments due for the first to fourth months after the rent abatement period. We were required to establish a deposit of \$4.5 million in the form of a letter of credit in October 2015; and, as such, \$4.5 million was recorded in “Long-term restricted cash” in the consolidated balance sheet as of both December 31, 2016 and December 31, 2015. The landlord is obligated to construct certain shell improvements at the landlord’s cost and expense and provide us with improvement allowances in the amount of \$12.6 million.

Under the O'Brien Lease, we expect to pay approximately \$79.2 million in rent and \$24.0 million in operating expenses over the expected lease term. In addition to the lease payments, we are also required to reimburse the landlord for certain improvement costs in excess of the tenant improvement allowances provided. These improvement costs, along with the costs associated with the anticipated move to the O'Brien Premises, are expected to be substantial in nature. These future expenditures are expected to be partially offset by the \$5.1 million of future Landlord Payments from our Existing Landlord as described above.

As of December 31, 2016, the future annual minimum lease payments under all noncancelable operating leases with remaining term in excess of one year are as follows:

Years ending December 31,	Amount (in thousands)
2017	\$ 4,569
2018	6,949
2019	6,930
2020	7,056
2021	7,272
Thereafter	46,710
Total minimum lease payments	\$ 79,486

Rent expense for the years ended December 31, 2016, 2015 and 2014 was \$0.2 million, \$1.1 million and \$2.2 million, respectively. Rent expense decreased for the year ended December 31, 2016 due to the rent abatements in 2016. We are also required to pay our share of operating expenses with respect to the facilities in which we operate.

In addition, we have other purchase commitments of an estimated amount of approximately \$18.0 million consisting of open purchase orders and contractual obligations in the ordinary course of business, including commitments with contract manufacturers and suppliers for which we have not received the goods or services, and acquisition and licensing of intellectual property. A majority of these purchase obligations are due within a year. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

Contingencies

We become subject to claims and assessments from time to time in the ordinary course of business. We accrue liabilities for such matters when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Legal Proceedings

On November 2, 2016, we filed a complaint against Oxford Nanopore Technologies Ltd., Oxford Nanopore Technologies, Inc. and Metrichor, Ltd. (together, "ONT") with the U.S. International Trade Commission ("USITC") for patent infringement. On December 5, 2016, the USITC provided notice that an investigation had been instituted based on the complaint. We are seeking exclusionary relief with respect to several ONT products, including ONT's MinION and PromethION devices. The complaint is based on our U.S. Patent No. 9,404,146, entitled "Compositions and methods for nucleic acid sequencing" which covers novel methods for sequencing single nucleic acid molecules using linked double-stranded nucleic acid templates, providing improved sequencing accuracy. On March 1, 2017, we filed an amendment complaint to add a second patent in the same patent family, U.S. Patent No. 9,542,527, which was granted on January 10, 2017, to the investigation. We are seeking, among other things, an exclusion order permanently barring entry of infringing ONT products into the United States, and a cease and desist order preventing ONT from advertising and selling infringing products in the United States. The estimated financial effect associated with this complaint cannot be made as of this 10-K filing time.

On February 2, 2017, we filed a claim in the High Court of England and Wales against Oxford Nanopore Technologies Ltd. and Metrichor, Ltd. for infringement of Patent EP(UK) 3 025 542, which is in the same patent family as the patents asserted in the USITC action referred to above. We are seeking remedies including injunctive relief, damages, and costs.

From time to time, we may also be involved in a variety of other claims, lawsuits, investigations and proceedings relating to securities laws, product liability, patent infringement, contract disputes, employment and other matters that arise in the normal course of our business. In addition, third parties may, from time to time, assert claims against us in the form of letters and other communications. We record a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We currently do not believe that the ultimate outcome of any of the matters described above is probable or reasonably estimable, or that these matters will have a material adverse effect on our business; however, the results of litigation and claims are inherently unpredictable. Regardless of the outcome, litigation can have an adverse impact on us because of litigation and settlement costs, diversion of management resources and other factors.

Indemnification

Pursuant to Delaware law and agreements entered into with each of our directors and officers, we may have obligations, under certain circumstances, to hold harmless and indemnify each of our directors and officers against losses suffered or incurred by the indemnified party in connection with their service to us, and judgments, fines, settlements and expenses related to claims arising against such directors and officers to the fullest extent permitted under Delaware law, our bylaws and certificate of incorporation. We also enter and have entered into indemnification agreements with our directors and officers that may require us to indemnify them against liabilities that arise by reason of their status or service as directors or officers, except as prohibited by applicable law. In addition, we may have obligations to hold harmless and indemnify third parties involved with our fund raising efforts and their respective affiliates, directors, officers, employees, agents or other representatives against any and all losses, claims, damages and liabilities related to claims arising against such parties pursuant to the terms of agreements entered into between such third parties and us in connection with such fund raising efforts. To the extent that any such indemnification obligations apply to the lawsuits described above, any associated expenses incurred are included within the related accrued litigation expense amounts. No additional liability associated with such indemnification obligations has been recorded at December 31, 2016.

NOTE 8. INCOME TAXES

A reconciliation between the statutory federal income tax and our effective tax rates as a percentage of loss before income taxes are as follows:

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	Years ended December 31,					
	2016		2015		2014	
Statutory tax rate	35.0	%	35.0	%	35.0	%
State tax rate, net of federal benefit	5.4		(3.5)		3.8	
Stock-based compensation	(1.6)		(4.0)		(1.3)	
R&D credit	5.0		11.0		4.0	
Other	(0.9)		(0.6)		(0.0)	
Change in valuation allowance	(42.9)		(37.9)		(41.5)	
Effective income tax rate	0.0	%	0.0	%	0.0	%

Temporary differences and carryforwards that gave rise to significant portions of deferred taxes are as follows (in thousands):

	December 31,	
	2016	2015
Deferred tax assets:		
Net operating loss carryforwards	\$ 264,183	\$ 235,659
Research and development credits	32,043	28,346
Depreciation	1,170	1,403
Accruals and reserves	20,088	20,385
Total deferred tax assets	317,484	285,793
Less: Valuation allowance	(317,412)	(285,556)
Deferred tax liabilities:		
Deferred rent	(72)	(237)
Net deferred tax assets	\$ —	\$ —

Due to uncertainties surrounding the realization of deferred tax assets through future taxable income, we have provided a full valuation allowance and, therefore, have not recognized any benefits from net operating losses and other deferred tax assets.

A valuation allowance is recorded when it is more likely than not that all or some portion of the deferred income tax assets will not be realized. We regularly assess the need for a valuation allowance against our deferred income tax assets by considering both positive and negative evidence related to whether it is more likely than not that our deferred income tax assets will be realized. In evaluating our ability to recover our deferred income tax assets within the jurisdiction from which they arise, we consider all available positive and negative evidence, including scheduled reversals of deferred income tax liabilities, projected future taxable income, tax-planning strategies, and results of recent operations. Accordingly, we have provided a full valuation allowance against our net deferred tax assets as of December 31, 2016 and 2015, respectively

For the year ended December 31, 2016, our valuation allowance increased to \$317.4 million primarily because of an increase in deferred tax assets related to net operating losses, state tax credits, and changes in accruals and reserves. For the year ended December 31, 2015, our valuation allowance increased to \$285.6 million primarily because of an

increase in deferred tax assets related to net operating losses, federal and state tax credits, and changes in accruals and reserves.

As of December 31, 2016, we had federal and state net operating loss carryforwards of approximately \$684.0 million and \$574.1 million, respectively, available to reduce future taxable income, if any. The federal net operating loss carryforward begins expiring in 2024, and the state net operating loss carryforward have expiration in 2016 and beyond.

We also had federal and California state research and development credit carryforwards of approximately \$26.9 million and \$29.0 million, respectively, as of December 31, 2016. The federal research and development credits begin expiring in 2024 if not utilized. The California tax research and development credits can be carried forward indefinitely.

Tax attributes related to stock option windfall deductions are not recorded until they result in a reduction of cash tax payable. The tax effected benefit of the excess tax deductions for federal and state purposes of \$6.0 million and \$0.4 million, respectively, will be recorded to additional paid-in capital when they reduce cash taxes payable.

The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carryforwards in certain situations where equity transactions result in a change of ownership as defined by Internal Revenue Code Section 382. In the event we experience an additional ownership change for tax purposes, utilization of our United States net operating loss and tax credit carryforwards could be limited.

As of December 31, 2016, our total unrecognized tax benefit was \$16.8 million, of which none of the tax benefit, if recognized, would affect the effective income tax rate due to the valuation allowance that currently offsets deferred tax assets. We do not anticipate the total amount of unrecognized income tax benefits to significantly increase or decrease in the next 12 months.

A reconciliation of the beginning and ending unrecognized tax benefit balance is as follows (in thousands):

Balance as of December 31, 2013	\$ 11,634
Increase in balance related to tax positions taken in prior year	2,959
Increase in balance related to tax positions taken during current year	2,359
Balance as of December 31, 2014	16,952
Decrease in balance related to tax positions taken in prior year	(44)
Increase in balance related to tax positions taken during current year	1,827
Balance as of December 31, 2015	18,735
Decrease in balance related to tax positions taken in prior year	(3,892)
Increase in balance related to tax positions taken during current year	1,942
Balance as of December 31, 2016	\$ 16,785

Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. As of December 31, 2016 and 2015, we had no accrued interest or penalties due to our net operating losses available to offset any tax adjustment. We file U.S. federal and various state income tax returns. For U.S. federal and state income tax purposes, the statute of limitations currently remains open for the years ending December 31, 2013 to present and December 31, 2012 to present, respectively. In addition, all of the net operating losses and research and development credit carryforwards that may be utilized in future years may be subject to examination. We are not currently under examination by income tax authorities in any jurisdiction.

NOTE 9. STOCKHOLDERS' EQUITY

Preferred Stock

Our Certificate of Incorporation, as amended and restated in October 2010 in connection with the closing of our initial public offering, authorizes us to issue 1,000,000,000 shares of \$0.001 par value common stock and 50,000,000 shares of \$0.001 par value preferred stock. As of December 31, 2016 and 2015, there were no shares of preferred stock issued or outstanding.

Common Stock

Common stockholders are entitled to dividends when and if declared by our board of directors. There have been no dividends declared to date. The holder of each share of common stock is entitled to one vote.

On October 5, 2012, we entered into a sales agreement pursuant to which we sold shares of our common stock having an aggregate offering price of approximately \$30.0 million through an "at-the-market" offering. On November 8, 2013,

we amended the sales agreement to increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million. On February 3, 2015, we amended the sales agreement again in order to further increase the shares of our common stock available for sale pursuant to the sales agreement, and pursuant to such amendment, sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million. On February 3, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Such aggregate offering price of shares of our common stock was in addition to the shares sold under the original sales agreement, dated October 5, 2012, the first amendment to the sales agreement, dated November 8, 2013, and the second amendment to the sales agreement, dated February 3, 2015. Pursuant to the prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million. On May 18, 2016, we filed a prospectus supplement pursuant to which we could offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$30.0 million under the sales agreement. Pursuant to such prospectus supplement, we sold additional shares of our common stock for an aggregate offering price of approximately \$30.0 million.

On February 2, 2017, we filed an additional prospectus supplement pursuant to which we may offer and sell, from time to time, additional shares of our common stock having an aggregate offering price of up to \$60.0 million under the sales agreement.

We pay a commission equal to 3% of the gross proceeds from the sale of shares of our common stock under the sales agreement. We are not obligated to sell shares of our common stock under the sales agreement.

Subject to certain exceptions set forth in our existing Facility Agreement, holders of our Notes may elect to receive 25% of the net proceeds from financing activities that include an equity component as prepayment of the Notes to be applied first, to accrued and unpaid interest and second, to principal. To the extent we raise additional capital in the future through the sale of common stock, including without limitation, sales of common stock pursuant to an “at-the-market” offering program, we may be obligated, at the election of the holders, to pay 25% of the net proceeds from any such financing activities as partial payment of the Notes.

Warrants

In connection with the execution of the Facility Agreement, we issued immediately exercisable warrants to purchase 5.5 million shares of common stock at an exercise price per share initially equal to \$2.63, all of which were outstanding at December 31, 2015. The number of shares of common stock into which the warrants are exercisable and the exercise price will be adjusted to reflect any stock splits, payment of stock dividends, recapitalizations, reclassifications or other similar adjustments in the number of outstanding shares of common stock. The exercise price may also be adjusted to reflect certain dividends or other distributions, including distributions of stock or other securities, property or options by way of a dividend, spin off, reclassification, corporate rearrangement or similar transaction.

During the year ended December 31, 2016, warrants to purchase 5.5 million shares of common stock were net exercised, resulting in the issuance of approximately 4.2 million shares. The cashless net exercises of the warrants did not result in any additional funds being collected by us.

As of December 31, 2016, no warrants remained outstanding.

Equity Plans

As of December 31, 2016, we had three active equity plans: 1) the 2010 Equity Incentive Plan or “2010 Plan,” 2) the 2010 Outside Director Equity Incentive Plan or “2010 Director Plan,” and 3) the 2010 Employee Stock Purchase Plan or “ESPP”, all of which we adopted upon the effectiveness of our initial public offering in October 2010. Prior to the adoption of these plans, we granted options pursuant to the 2004 Equity Incentive Plan and 2005 Stock Plan. Upon termination of the predecessor plans, the shares available for grant at the time of termination, and shares subsequently returned to the plans upon forfeiture or option termination, were transferred to the successor plan in effect at the time of share return.

We issue new shares of common stock upon the exercise of stock options.

2010 Equity Incentive Plan and Outside Director Equity Incentive Plan

Stock options granted under the 2010 Plan may be either Incentive Stock Option (“ISO”) or Non-Qualified Stock Option (“NSO”). ISOs may be granted only to employees. NSOs may be granted to employees, consultants and directors. Stock options under the 2010 Plan may be granted with a term of up to ten years and at prices no less than the fair market value of our common stock on the date of grant. To date, stock options granted to existing employees generally vest over four years on a monthly basis and stock options granted to new employees vest at a rate of 25% upon the first anniversary of the vesting commencement date and 1/48th per month thereafter. In January 2017, an additional 4.6 million shares were reserved under the 2010 Plan.

Stock options granted under the 2010 Director Plan provide for the grant of NSOs. Stock options under the 2010 Plan may be granted with a term of up to ten years and at prices no less than the fair market value of our common stock on the date of grant. To date, stock options granted to existing directors generally vest over one year on a monthly basis

and stock options granted to new directors generally vest over three years at a rate of one-third upon the first anniversary of the vesting commencement date and 1/36th per month thereafter.

As of December 31, 2016 we had an aggregate of 6.5 million shares of common stock reserved for future issuance under the 2010 Plan and 2010 Director Plan.

2010 Employee Stock Purchase Plan

We adopted the ESPP in October 2010. Our ESPP permits eligible employees to purchase common stock at a discount through payroll deductions during defined offering periods. Each offering period will generally consist of four purchase periods, each purchase period being approximately six months. The price at which the stock is purchased is equal to the lower of 85% of the fair market value of the common stock at the beginning of an offering period or at the end of a purchase period. Each offering period will generally end and the shares will be purchased twice yearly on March 1 and September 1. If the stock price at the end of the purchase period is lower than the stock price at the beginning of the offering period, that offering period will then be terminated and new offering period comes to place. As of December 31, 2016, 738,063 shares of our common stock remain available for issuance under the Plan. The ESPP provides for an annual increase to the shares available for issuance at the beginning of each calendar year equal to 2% of the common shares then outstanding. During January 2017, an additional 1.9 million shares were reserved under the ESPP.

The following table summarizes stock option activity for all stock option plans for the year ended December 31, 2016 (in thousands, except per share amounts):

	Shares available for grant	Stock Options Outstanding		
		Number of shares	Exercise price	Weighted average exercise price
Balances, December 31, 2015	5,814	19,468	\$ 0.70 – 16.00	\$ 5.69
Additional shares reserved	4,799			
Options granted	(4,228)	4,228	\$ 3.89 – 12.85	\$ 8.68
Options exercised	—	(745)	\$ 0.70 – 8.90	\$ 3.37
Options canceled	450	(450)	\$ 1.16 – 16.00	\$ 7.29
Balances, December 31, 2016	6,835	22,501	\$ 1.16 – 16.00	\$ 6.30

The following table summarizes information with respect to stock options outstanding and exercisable under the plans at December 31, 2016:

Exercise price	Options Outstanding			Options Exercisable		
	Number	Weighted average remaining contractual life (Years)	Weighted average exercise price	Number	Weighted average exercise price	Weighted average exercise price
\$ 0.00 – 1.60	711,212	5.85	\$ 1.18	573,528	\$ 1.18	\$ 1.18
\$ 1.60 – 3.20	3,551,871	5.15	\$ 2.43	3,140,084	\$ 2.46	\$ 2.46
\$ 3.20 – 4.80	3,939,254	5.65	\$ 4.12	3,553,978	\$ 4.10	\$ 4.10
\$ 4.80 – 6.40	3,326,312	7.12	\$ 5.66	2,011,713	\$ 5.67	\$ 5.67
\$ 6.40 – 8.00	3,818,451	7.35	\$ 7.14	2,012,847	\$ 7.03	\$ 7.03
\$ 8.00 – 9.60	4,438,277	7.74	\$ 8.78	1,727,277	\$ 8.66	\$ 8.66
\$ 9.60 – 11.20	1,590,991	8.12	\$ 10.18	585,398	\$ 10.37	\$ 10.37
\$ 11.20 – 12.80	607,902	4.06	\$ 12.11	607,902	\$ 12.11	\$ 12.11
\$ 12.80 – 14.40	385,500	4.03	\$ 13.87	383,600	\$ 13.87	\$ 13.87
\$ 14.40 – 16.00	131,500	3.86	\$ 15.99	131,500	\$ 15.99	\$ 15.99
	22,501,270	6.59	\$ 6.30	14,727,827	\$ 5.73	\$ 5.73

The aggregate intrinsic value of the outstanding and exercisable options presented in the table above totaled \$7.3 million and \$6.3 million, respectively. The aggregate intrinsic value represents the total pretax intrinsic value (i.e., the difference between \$3.80, our closing stock price on the last trading day of our fourth quarter of 2016 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2016. The aggregate intrinsic value changes at each reporting date based on the fair market value of our common stock. The weighted average remaining contractual life for exercisable options is 5.62 years.

The vested and expected to vest option as of December 31, 2016 totaled 19,636,962, with aggregate intrinsic value of \$6.9 million, weighted average exercise price per share of \$6.17 and weighted average remaining contractual life of 6.34 years.

The total intrinsic value of stock options exercised during the years ended December 31, 2016, 2015 and 2014 was \$4.7 million, \$3.5 million and \$2.0 million, respectively.

The total fair value of stock options vested during the years ended December 31, 2016, 2015 and 2014 was \$20.7 million, \$7.3 million and \$6.0 million, respectively.

Stock-based Compensation

Total stock-based compensation expense consists of the following (in thousands):

	Years Ended December 31,		
	2016	2015	2014
Cost of revenue	\$ 2,133	\$ 1,313	\$ 758
Research and development	8,257	5,196	3,785
Sales, general and administrative	9,172	7,331	5,400
Total stock-based compensation expense	\$ 19,562	\$ 13,840	\$ 9,943

As of December 31, 2016 and December 31, 2015, \$389,000 and \$315,000 of stock-based compensation cost was capitalized in inventory on our consolidated balance sheets, respectively.

The tax benefit of stock-based compensation expense was immaterial for the years ended December 31, 2016, 2015 and 2014.

Stock Options

We estimated the fair value of employee stock option using the Black-Scholes option pricing model. The fair value of employee stock options is being amortized on a straight-line basis over the requisite service period of the awards. For the years ended December 31, 2016, 2015 and 2014, the weighted average fair value at grant date per stock option was \$5.47, \$4.75 and \$3.81, respectively. We recorded stock-based compensation expense for stock options of \$15.7 million, \$10.2 million and \$7.8 million for the years ended December 31, 2016, 2015 and 2014, respectively.

For the years ended December 31, 2016, 2015 and 2014, the fair value of employee stock options was estimated using the following weighted average assumptions:

	Years Ended December 31,		
	2016	2015	2014
Expected term (years)	6.1 years	6.1 years	6.1 years
Expected volatility	70.0%	70.0%	70.0%
Risk-free interest rate	1.5%	1.7%	1.9%
Dividend yield	—	—	—

As of December 31, 2016, \$23.4 million of total unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 2.7 years. Future option grants will increase the amount of compensation expense to be recorded in those future periods. Cash received from option exercises for the years ended December 31, 2016, 2015 and 2014 was \$2.5 million, \$3.0 million and \$1.6 million, respectively.

ESPP

We estimated the fair value of ESPP using the Black-Scholes option pricing model. For the years ended December 31, 2016, 2015 and 2014, weighted average fair value at grant date for ESPP was \$4.21, \$2.20 and \$2.98, respectively. We recorded stock-based compensation expense for ESPP of \$3.7 million, \$3.6 million and \$2.1 million for the years ended December 31, 2016, 2015 and 2014, respectively.

For the years ended December 31, 2016, 2015 and 2014, the fair value of ESPP was estimated using the following assumptions:

	Years Ended December 31,		
	2016	2015	2014
Expected term (years)	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0
Expected volatility	70.0%	70.0%	70.0%
Risk-free interest rate	0.5%-0.9%	0.1%-0.7%	0.1%-0.5%
Dividend yield	—	—	—

For the years ended December 31, 2016, 2015 and 2014, 1.3 million shares, 1.1 million shares and 1.3 million shares of common stock were purchased under the ESPP, respectively. Cash received through the ESPP for the years ended December 31, 2016, 2015 and 2014 was \$5.2 million, \$4.4 million and \$2.3 million, respectively.

NOTE 10. NET LOSS PER SHARE

The following table presents the computation of basic and diluted net loss per share (in thousands, except per share amounts):

	Years Ended December 31,		
	2016	2015	2014
Numerator:			
Net loss	\$ (74,375)	\$ (31,696)	\$ (66,160)
Denominator:			
Weighted average shares used in computation of basic and diluted net loss per share	89,148	75,614	70,475
Basic and diluted net loss per share	\$ (0.83)	\$ (0.42)	\$ (0.94)

The following options outstanding and warrants to purchase common stock were excluded from the computation of diluted net loss per share for the periods presented because the effect of including such shares would have been antidilutive in the periods presented:

(in thousands)	Years Ended December		
	2016	2015	2014
Options outstanding	22,501	19,468	16,491
Warrants to purchase common stock	—	5,500	5,500

NOTE 11. SEGMENT AND GEOGRAPHIC INFORMATION

We are organized as, and operate in, one reportable segment: the development, manufacturing and marketing of an integrated platform for genetic analysis. Our chief operating decision-maker is our Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis for purposes of evaluating financial performance and allocating resources, accompanied by information about revenue by geographic regions. Our assets are primarily located in the United States of America and not allocated to any specific region and we do not measure the performance of geographic regions based upon asset-based metrics. Therefore, geographic information is presented only for revenue. Revenue by geographic region is based on the ship to address on the customer order.

A summary of our revenue by geographic location for the years ended December 31, 2016, 2015 and 2014 is as follows, with Roche related contractual revenue classified as revenue from the United States:

(in millions)	Years Ended December		
	2016	2015	2014
North America	\$ 50.8	\$ 68.8	\$ 34.8
Europe	20.0	9.0	10.1
Asia	19.9	15.0	15.7
Total	\$ 90.7	\$ 92.8	\$ 60.6

NOTE 12. UNAUDITED SELECTED QUARTERLY FINANCIAL DATA

The following tables summarize the unaudited quarterly financial data for the last two fiscal years:

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(in thousands, except per share data)	Fiscal 2016 Quarter Ended			
	March 31,	June 30,	September 30,	December 31,
Total revenue	\$ 19,127	\$ 20,747	\$ 25,118	\$ 25,722
Total gross profit	9,504	10,644	12,638	11,374
Total operating expenses	28,069	28,714	29,373	29,248
Loss from operations	(18,565)	(18,070)	(16,735)	(17,874)
Net loss	(19,352)	(18,499)	(17,494)	(19,030)
Basic and diluted net loss per share	\$ (0.23)	\$ (0.21)	\$ (0.19)	\$ (0.21)
Weighted average shares used in computing net loss per share (1)	83,604	88,148	92,110	92,660
	Fiscal 2015 Quarter Ended			
	March 31,	June 30,	September 30,	December 31,
Total revenue	\$ 17,645	\$ 24,939 (2)	\$ 13,917	\$ 36,281 (2)
Total gross profit	5,927	14,506	6,551	26,466
Total operating expenses	25,255	25,864	3,937 (3)	27,528
Income (loss) from operations	(19,328)	(11,358)	2,614 (3)	(1,062)
Net income (loss)	(20,173)	(11,935)	1,821 (3)	(1,409)
Net income (loss) per share				
Basic	\$ (0.27)	\$ (0.16)	\$ 0.02 (3)	\$ (0.02)
Diluted	\$ (0.27)	\$ (0.16)	\$ 0.02 (3)	\$ (0.02)
Weighted average shares used in computing net income (loss) per share (1)				
Basic	74,149	74,733	75,205	78,327
Diluted	74,149	74,733	80,479	78,327

(1) In 2015 and 2016 we established various “at-the-market” offerings pursuant to which we offered and sold shares of our common stock. See “Note 9. Stockholders’ Equity” for additional information

(2) As provided in the Roche Agreement, we achieved the second and third (final) development milestones and recognized the related \$10.0 million and \$20.0 million, respectively, as contractual revenue during the quarters ended June 30, 2015 and December 31, 2015, respectively. See “Note 3. Contractual Revenue” for additional information.

(3) For the quarter ended September 30, 2015, we recognized a one-time gain on lease amendments of \$23.0 million, which was recorded in operating expenses on our statement of operations and comprehensive income (loss) for the period. See “Note 7. Commitments and Contingencies” for additional information.

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ITEM 9A.CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer, and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this Annual Report on Form 10-K. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our chief executive officer, chief financial officer and our principal accounting officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Principal Accounting Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (COSO). Based on our evaluation under this framework our management concluded that our internal control over financial reporting was effective as of December 31, 2016.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the valuation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our fourth fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting.

The effectiveness of our internal control over financial reporting as of December 31, 2016, has been audited by Ernst & Young LLP, our independent registered public accounting firm, as stated in their report which is included as follows.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of Pacific Biosciences of California, Inc.

We have audited Pacific Biosciences of California, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). Pacific Biosciences of California, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Pacific Biosciences of California, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pacific Biosciences of California, Inc. as of December 31, 2016 and 2015, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2016 of Pacific Biosciences of California, Inc. and our report dated March 6, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Redwood City, California

March 6, 2017

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ITEM 9B.OTHER INFORMATION

None.

PART III

ITEM 10.DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

Information responsive to this item is incorporated herein by reference to our definitive proxy statement with respect to our 2017 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 11.EXECUTIVE COMPENSATION.

Information responsive to this item is incorporated herein by reference to our definitive proxy statement with respect to our 2017 Annual Meeting of Stockholder to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 12.SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Information responsive to this item is incorporated herein by reference to our definitive proxy statement with respect to our 2017 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 13.CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

Information responsive to this item is incorporated herein by reference to our definitive proxy statement with respect to our 2017 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 14.PRINCIPAL ACCOUNTING FEES AND SERVICES.

Information responsive to this item is incorporated herein by reference to our definitive proxy statement with respect to our 2017 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART IV

ITEM 15.EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

(a)The following documents are filed as part of, or incorporated by reference into, this Annual Report on Form 10-K:

1. Financial Statements: See Index to Consolidated Financial Statements under Item 8 of this Annual Report on Form 10-K.
2. Financial Statement Schedules: All schedules are omitted because they are not required, are not applicable or the information is included in the consolidated financial statements or notes thereto.

3. Exhibits: We have filed, or incorporated by reference into this Annual Report on Form 10-K, the exhibits listed on the accompanying Exhibit Index immediately following the signature page of this Annual Report on Form 10-K.

(b)Exhibits: See Item 15(a)(3), above.

(c)Financial Statement Schedules: See Item 15(a)(2), above.

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC

By: /S/ SUSAN K. BARNES

Susan K. Barnes

Executive Vice President, Chief Financial Officer and Principal Accounting Officer

Date: March 6, 2017

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Michael Hunkapiller and Susan K. Barnes, jointly and severally, as his or her true and lawful attorney-in-fact and agent, with full power of substitution, each with power to act alone, to sign and execute on behalf of the undersigned any and all amendments to this Annual Report on Form 10-K, and to perform any acts necessary in order to file the same, with all exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requested and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or their or his or her substitutes, shall do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Michael Hunkapiller	Executive Chairman, Chief Executive Officer and President	March 6, 2017
Michael Hunkapiller		
/s/ Susan K. Barnes	Executive Vice President, Chief Financial Officer and Principal Accounting Officer	March 6, 2017
Susan K. Barnes		
/s/ David Botstein	Director	March 6, 2017
David Botstein		
/s/ Brook Byers	Director	March 6, 2017

Brook Byers

/s/ William W. Ericson Director

March 6, 2017

William W. Ericson

/s/ Randall S. Director
Livingston

March 6, 2017

Randall S. Livingston

/s/ John F. Milligan Director

March 6, 2017

John F. Milligan

/s/ Marshall L. Mohr Director

March 6, 2017

Marshall L. Mohr

/s/ Kathy Ordoñez Director

March 6, 2017

Kathy Ordoñez

/s/ Lucy Shapiro Director

March 6, 2017

Lucy Shapiro

Exhibit Index

Incorporated by reference herein

Exhibit Number	Description	Form	Exhibit No.	Filing Date
3.1	Amended and Restated Certificate of Incorporation	10-K	3.1	March 23, 2011
3.2	Amended and Restated Bylaws	10-K	3.2	March 23, 2011
4.1	Specimen Common Stock Certificate	S-1/A	4.1	October 1, 2010
10.1+	Form of Director and Executive Officer Indemnification Agreement	S-1	10.1	August 16, 2010
10.3+	2005 Stock Plan and forms of option agreements thereunder	S-1	10.3	August 16, 2010
10.4+	2010 Equity Incentive Plan and forms of option agreements thereunder	S-1	10.4	August 16, 2010
10.5+		S-1	10.5	August 16, 2010

	2010 Employee Stock Purchase Plan and forms of agreement thereunder			
10.6+	2010 Outside Director Equity Incentive Plan and forms of agreement thereunder	S-1	10.6	August 16, 2010
10.7†	Exclusive License Agreement by and between the Registrant and Cornell Research Foundation, Inc., dated as of February 1, 2004	S-1/A	10.8	October 22, 2010
10.8†	License Agreement by and between the Registrant and GE Healthcare Bio-Sciences Corp., dated as of September 11, 2006	S-1/A	10.9	October 22, 2010
10.9†	Exclusive License Agreement by and between the Registrant and Indiana University Research and Technology Corporation, dated May 15, 2005	S-1/A	10.10	October 19, 2010
10.10	Amended and Restated Lease	S-1	10.11	August 16, 2010

	Agreement by and between the Registrant and Menlo Business Park, LLC, dated as of December 17, 2007			
10.11	Lease Agreement by and between the Registrant and Menlo Business Park LLC, dated August 14, 2009	S-1	10.12	August 16, 2010
10.12	Industrial Lease Agreement by and between the Registrant and AMB Property, L.P., dated December 10, 2009	S-1	10.13	August 16, 2010
10.13	Third Amendment to the December 10, 2009 Industrial Lease by and between the Registrant and AMB Property, L.P. dated December 29, 2010	10-K	10.14	March 23, 2011
10.14	Industrial Lease Agreement by and between the Registrant and AMB Property, L.P., dated September 24, 2009	S-1	10.14	August 16, 2010
10.15	Third Amendment to the September 24, 2009	10-K	10.16	March 23, 2011

	Industrial Lease by and between the Registrant and AMB Property, L.P. dated December 29, 2010				
10.16	First Amendment to the September 24, 2009 Industrial Lease Agreement by and between the Registrant and AMB Property, L.P., dated as of May 19, 2010	S-1	10.15		August 16, 2010
10.17	Industrial Lease Agreement by and between the Registrant and AMB Property, L.P., dated February 8, 2010	S-1	10.16		August 16, 2010
10.18	First Amendment to the February 8, 2010 Industrial Lease by and between the Registrant and AMB Property, L.P. dated December 29, 2010	10-K	10.19		March 23, 2011
10.19	Lease by and between the Registrant and Willow Park Holding Company I, L.P. dated December 17, 2010	10-K	10.20		March 23, 2011

10.20	Lease by and between the Registrant and AMB Property, L.P. dated December 17, 2010	10-K	10.21	March 23, 2011
10.21	Lease by and between the Registrant and Willow Park Holding Company II, L.P. dated December 17, 2010	10-K	10.21	March 23, 2011

- 10.22+ Letter Relating to
Employment Terms
by and between the
Registrant and
Susan K. Barnes
effective
September 15,
2010 S-1/A 10.19 September 20, 2010
- 10.23+ Change in Control
Severance
Agreement by and
between the
Registrant and
Susan K. Barnes
effective
September 9, 2010 S-1/A 10.20 September 20, 2010
- 10.24+ Letter Relating to
Employment Terms
by and between the
Registrant and
James Michael
Phillips effective
September 15,
2010 S-1/A 10.23 September 20, 2010
- 10.25+ Change in Control
Severance
Agreement by and
between the
Registrant and
James Michael
Phillips effective
September 9, 2010 S-1/A 10.24 September 20, 2010
- 10.26+ Employment
Agreement by and
between the
Registrant and
Michael
Hunkapiller dated
January 5, 2012 10-K 10.32 March 1, 2012
- 10.27+ Change in Control 10-K 10.33 March 1, 2012
Severance
Agreement by and
between the
Registrant and

- Michael
Hunkapiller dated
January 5, 2012
- 10.28 Controlled Equity
Offering Sales
Agreement, dated
October 5, 2012, by
and between the
Registrant and
Cantor
Fitzgerald & Co. 8-K 10.1 October 5, 2012
- 10.29 Amendment No. 1
to Controlled
Equity Offering
Sales Agreement,
dated November 8,
2013, by and
between the
Registrant and
Cantor Fitzgerald
& Co. 8-K 10.1 November 12, 2013
- 10.30 Amendment No. 2
to Controlled
Equity Offering
Sales Agreement,
dated February 3,
2015, by and
between the
Registrant and
Cantor Fitzgerald
& Co. 8-K 10.1 February 3, 2015
- 10.31+ Letter Agreement
between the
Registrant and
Michael
Hunkapiller, dated
December 14, 2012 8-K 10.1 December 14, 2012
- 10.32+ Letter Agreement
between the
Registrant and
Susan K. Barnes,
dated
December 14, 2012 8-K 10.2 December 14, 2012
- 10.33 Facility Agreement, 8-K 10.1 February 5, 2013
dated February 5,

2013 by and among
the Registrant and
the entities listed
on the signature
pages thereof.

- 10.34 Security Agreement, dated February 5, 2013 by and among Pacific Biosciences of California, Inc. and the entities listed on the signature pages thereof. 8-K 10.3 February 5, 2013
- 10.35† Development, Commercialization and License Agreement by and between the Registrant and F. Hoffman-La Roche Ltd. Dated September 24, 2013. 10-Q 10.1 November 12, 2013
- 10.36 Fifth Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015. 8-K 10.1 April 1, 2015
- 10.37 Fifth Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015. 8-K 10.2 April 1, 2015
- 10.38 Second Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, 8-K 10.3 April 1, 2015

	dated March 30, 2015.			
10.39	Second Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015.	8-K	10.4	April 1, 2015
10.40	Second Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015.	8-K	10.5	April 1, 2015
10.41	Second Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015.	8-K	10.6	April 1, 2015
10.42	Third Amendment to Lease Agreement with Peninsula Innovation Partners, LLC, dated March 30, 2015.	8-K	10.7	April 1, 2015

- 10.43 Lease
Amendment
Agreement by
and between the
Registrant and
Peninsula
Innovation
Partners, LLC,
dated July 23,
2015. 10-Q 10.1 August 5, 2015
- 10.44† Lease
Agreement by
and between the
Registrant and
Menlo Park
Portfolio II,
LLC, dated July
22, 2015. 10-Q 10.2 August 5, 2015
- 10.45+ Letter
Agreement
between the
Registrant and
Michael
Hunkapiller,
dated May 17,
2016. 8-K 10.1 May 19, 2016
- 10.46+ Letter
Agreement
between the
Registrant and
Susan K.
Barnes, dated
May 17, 2016. 8-K 10.2 May 19, 2016
- 10.47† Second Lease
Amendment
Agreement by
and between the
Registrant and
Peninsula
Innovation
Partners, LLC,
dated June 10,
2016. 10-Q 10.1 August 4, 2016
- 10.48+ Employment
Agreement by

- and between the Registrant and Kevin Corcoran dated November 21, 2007.
- 10.49+ Change in Control Severance Agreement by and between the Registrant and Kevin Corcoran effective September 9, 2010.
- 10.50† First Amendment to Lease Agreement by and between the Registrant and Menlo Park Portfolio II, LLC, dated December 23, 2016.
- 10.51 Third Lease Amendment Agreement by and between the Registrant and Peninsula Innovation Partners, LLC, dated January 27, 2017.
- 12.1 Computation of Ratio of Earnings to Fixed Charges
- 21.1 List of Subsidiaries of the Registrant
- 23.1 Consent of Independent

Registered
Public
Accounting
Firm

31.1 Certification of
Chief Executive
Officer pursuant
to Exchange Act
Rules 13a-14(a)
and 15d-14(a),
as adopted
pursuant to
Section 302 of
the
Sarbanes-Oxley
Act of 2002

31.2 Certification of
Chief Financial
Officer pursuant
to Exchange Act
Rules 13a-14(a)
and 15d-14(a),
as adopted
pursuant to
Section 302 of
the
Sarbanes-Oxley
Act of 2002

32.1* Certification of
Chief Executive
Officer pursuant
to 18 U.S.C.
Section 1350, as
adopted
pursuant to
Section 906 of
the
Sarbanes-Oxley
Act of 2002

32.2* Certification of
Chief Financial
Officer pursuant
to 18 U.S.C.
Section 1350, as
adopted
pursuant to
Section 906 of

the
Sarbanes-Oxley
Act of 2002

101.INS XBRL Instance
Document

101.SCH XBRL
Taxonomy
Extension
Schema
Document

101.CAL XBRL
Taxonomy
Extension
Calculation
Linkbase
Document

101.DEF XBRL
Taxonomy
Extension
Definition
Linkbase
Document

101.LAB XBRL
Taxonomy
Extension
Labels
Linkbase
Document

101.PRE XBRL
Taxonomy
Extension
Presentation
Linkbase
Document

+Indicates management contract or compensatory plan

†Confidential treatment has been requested for portions of this exhibit. These portions have been omitted from this Registration Statement and have been filed separately with the Securities and Exchange Commission.

*The certifications attached as Exhibit 32.1 and 32.2 that accompany this Annual Report on Form 10-K are deemed furnished and not filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Pacific Biosciences of California, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Annual Report on Form 10-K, irrespective of any general incorporation language contained in such filing

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