

INFINITY PHARMACEUTICALS, INC.

Form 10-Q

May 06, 2015

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2015**

**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 000-31141**

**INFINITY PHARMACEUTICALS, INC.**

**(Exact name of registrant as specified in its charter)**

**Delaware** **33-0655706**  
**(State or other jurisdiction of** **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**784 Memorial Drive, Cambridge, Massachusetts 02139**  
**(Address of principal executive offices) (zip code)**  
**(617) 453-1000**  
**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 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

Number of shares of the registrant's Common Stock, \$0.001 par value, outstanding on April 30, 2015: 49,042,486

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**INFINITY PHARMACEUTICALS, INC.**

**FORM 10-Q**

**FOR THE QUARTER ENDED MARCH 31, 2015**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Unaudited Condensed Consolidated Financial Statements****INFINITY PHARMACEUTICALS, INC.****Condensed Consolidated Balance Sheets****(unaudited)****(in thousands, except share and per share amounts)**

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 223,045	\$ 307,405
Available-for-sale securities	10,008	25,321
Loan commitment asset, net (note 9)		647
Prepaid expenses and other current assets	6,317	11,195
<b>Total current assets</b>	<b>239,370</b>	<b>344,568</b>
Property and equipment, net	22,720	18,970
Long-term available-for-sale securities	508	519
Restricted cash	1,680	1,680
Long-term receivable (note 11)	3,006	3,006
Other assets	358	401
<b>Total assets</b>	<b>\$ 267,642</b>	<b>\$ 369,144</b>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 5,697	\$ 5,947
Accrued expenses	12,564	17,768
Due to Takeda, current		6,667
Deferred revenue, current	26,060	24,495
<b>Total current liabilities</b>	<b>44,321</b>	<b>54,877</b>
Deferred revenue, less current portion	79,581	85,510
Deferred rent (note 11)	4,082	3,375
Construction liability (note 11)	18,082	15,456
Other liabilities	497	454
<b>Total liabilities</b>	<b>146,563</b>	<b>159,672</b>
Commitments and contingencies		
Stockholders equity:		

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Preferred Stock, \$0.001 par value; 1,000,000 shares authorized, no shares issued and outstanding at March 31, 2015 and December 31, 2014

Common Stock, \$0.001 par value; 100,000,000 shares authorized, and 49,028,780 and 48,878,828 shares issued and outstanding, at March 31, 2015 and December 31, 2014, respectively	49	49
Additional paid-in capital	681,434	676,521
Accumulated deficit	(560,514)	(467,212)
Accumulated other comprehensive income	110	114
<b>Total stockholders' equity</b>	<b>121,079</b>	<b>209,472</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 267,642</b>	<b>\$ 369,144</b>

*The accompanying notes are an integral part of these unaudited, condensed consolidated financial statements.*

Table of Contents**INFINITY PHARMACEUTICALS, INC.****Condensed Consolidated Statements of Operations and Comprehensive Loss****(unaudited)****(in thousands, except share and per share amounts)**

	<b>Three Months Ended March 31,</b>	
	<b>2015</b>	<b>2014</b>
Collaboration revenue	\$ 4,363	\$
Operating expenses:		
Research and development	88,428	34,491
General and administrative	8,550	6,804
<b>Total operating expenses</b>	<b>96,978</b>	<b>41,295</b>
Loss from operations	(92,615)	(41,295)
Other income (expense):		
Interest expense	(647)	(1,139)
Investment and other income (loss)	(40)	168
<b>Total other income (expense)</b>	<b>(687)</b>	<b>(971)</b>
<b>Net loss</b>	<b>\$ (93,302)</b>	<b>\$ (42,266)</b>
Basic and diluted loss per common share	\$ (1.91)	\$ (0.87)
Basic and diluted weighted average number of common shares outstanding	48,939,383	48,348,767
Other comprehensive income (loss):		
Net unrealized holding losses on available-for-sale securities arising during the period	(4)	(1)
<b>Comprehensive loss</b>	<b>\$ (93,306)</b>	<b>\$ (42,267)</b>

*The accompanying notes are an integral part of these unaudited, condensed consolidated financial statements.*

**Table of Contents****INFINITY PHARMACEUTICALS, INC.****Condensed Consolidated Statements of Cash Flows****(unaudited)****(in thousands)**

	<b>Three Months Ended March 31,</b>	
	<b>2015</b>	<b>2014</b>
<b>Operating activities</b>		
Net loss	\$ (93,302)	\$ (42,266)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	354	468
Stock-based compensation including 401(k) match	3,751	3,744
Net amortization of premium/discount on available-for-sale securities	72	592
Non-cash interest expense on Due to Takeda amount		52
Amortization of loan commitment asset	647	1,139
Other, net	1	(30)
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	4,921	(1,050)
Accounts payable, accrued expenses and other liabilities	(5,778)	463
Due to Takeda	(6,667)	(6,667)
Deferred revenue	(4,364)	
Deferred rent	707	
Net cash used in operating activities	(99,658)	(43,555)
<b>Investing activities</b>		
Purchases of property and equipment	(1,112)	(176)
Purchases of available-for-sale securities		(12,536)
Proceeds from maturities of available-for-sale securities	15,248	41,172
Net cash provided by investing activities	14,136	28,460
<b>Financing activities</b>		
Proceeds from issuances of common stock related to stock incentive plans	1,162	1,952
Net cash provided by financing activities	1,162	1,952
Net decrease in cash and cash equivalents	(84,360)	(13,143)
Cash and cash equivalents at beginning of period	307,405	68,114
Cash and cash equivalents at end of period	\$ 223,045	\$ 54,971
<b>Supplemental schedule of noncash investing and financing activities</b>		
Loan commitment asset	\$	\$ 11,350
Facility fee	\$	\$ 3,000

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Fixed assets in accrued expenses	\$	367	\$
Increase in construction liability and CIP for amount paid by landlord	\$	2,626	\$
Warrants issued	\$		\$ 8,350

*The accompanying notes are an integral part of these unaudited, condensed consolidated financial statements.*



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**Infinity Pharmaceuticals, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(Unaudited)**

**1. Organization**

Infinity Pharmaceuticals, Inc. is an innovative biopharmaceutical company dedicated to discovering, developing and delivering best-in-class medicines to patients with difficult-to-treat diseases. As used throughout these unaudited, condensed consolidated financial statements, the terms Infinity, we, us, and our refer to the business of Infinity Pharmaceuticals, Inc. and its wholly-owned subsidiaries.

**2. Basis of Presentation**

These condensed consolidated financial statements include the accounts of Infinity and its wholly-owned subsidiaries. We have eliminated all significant intercompany accounts and transactions in consolidation.

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals and revisions of estimates, considered necessary for a fair presentation of the accompanying condensed consolidated financial statements have been included. Interim results for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2015.

The information presented in the condensed consolidated financial statements and related footnotes at March 31, 2015, and for the three months ended March 31, 2015 and 2014, is unaudited, and the condensed consolidated balance sheet amounts and related footnotes at December 31, 2014 have been derived from our audited financial statements. For further information, please refer to the consolidated financial statements and accompanying footnotes included in our annual report on Form 10-K for the fiscal year ended December 31, 2014, which was filed with the U.S. Securities and Exchange Commission on February 24, 2015.

**3. Significant Accounting Policies**

***Cash Equivalents and Available-For-Sale Securities***

Cash equivalents and available-for-sale securities primarily consist of money market funds, U.S. government-sponsored enterprise obligations, corporate obligations and mortgage-backed securities. Corporate obligations include obligations issued by corporations in countries other than the United States, including some obligations that have not been guaranteed by governments or government agencies. We consider all highly liquid investments with maturities of three months or less at the time of purchase to be cash equivalents. Cash equivalents, which consist of money market funds and corporate obligations, are stated at fair value. They are also readily convertible to known amounts of cash and have such short-term maturities that each presents insignificant risk of change in value due to changes in interest rates. Our classification of cash equivalents is consistent with prior periods.

We determine the appropriate classification of marketable securities at the time of purchase and reevaluate such designation at each balance sheet date. We have classified all of our marketable securities at March 31, 2015 and December 31, 2014 as available-for-sale. We carry available-for-sale securities at fair value, with the unrealized gains and losses reported in accumulated other comprehensive income, which is a separate component of stockholders equity.

We adjust the cost of available-for-sale debt securities for amortization of premiums and accretion of discounts to maturity. We include such amortization and accretion in investment and other income. The cost of securities sold is based on the specific identification method. We include in investment and other income interest and dividends on securities classified as available-for-sale.

We conduct periodic reviews to identify and evaluate each investment that is in an unrealized loss position to determine whether an other-than-temporary impairment exists. An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. Unrealized losses on available-for-sale debt securities that are determined to be temporary, and not related to credit loss, are recorded, net of tax, in accumulated other comprehensive income.

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For available-for-sale debt securities in an unrealized loss position, we perform an analysis to assess whether we intend to sell or whether we would more likely than not be required to sell the security before the expected recovery of the amortized cost basis. Where we intend to sell a security, or may be required to do so, the security's decline in fair value is deemed to be other-than-temporary, and the full amount of the unrealized loss is recorded within earnings as an impairment loss.

Regardless of our intent to sell a security, we perform additional analysis on all securities in an unrealized loss position to evaluate losses associated with the creditworthiness of the security. Credit losses are identified where we do not expect to receive cash flows sufficient to recover the amortized cost basis of a security and are recorded within earnings as an impairment loss.

***Segment Information***

We operate in one business segment, which focuses on drug discovery and development. We make operating decisions based upon performance of the enterprise as a whole and utilize our consolidated financial statements for decision making.

All of our revenues to date have been generated under research collaboration agreements.

***Basic and Diluted Net Loss per Common Share***

Basic net loss per share is based upon the weighted average number of common shares outstanding during the period. Diluted net loss per share is based upon the weighted average number of common shares outstanding during the period plus the effect of additional weighted average common equivalent shares outstanding during the period when the effect of adding such shares is dilutive. Common equivalent shares result from the assumed exercise of outstanding stock options (the proceeds of which are then assumed to have been used to repurchase outstanding stock using the treasury stock method) and the exercise of outstanding warrants (the proceeds of which have not been used for repurchases under the treasury stock method). In addition, the assumed proceeds under the treasury stock method include the average unrecognized compensation expense of stock options that are in-the-money. This results in the assumed buyback of additional shares, thereby reducing the dilutive impact of stock options. Common equivalent shares have not been included in the net loss per share calculations for the periods presented because the effect of including them would have been anti-dilutive. Total potential gross common equivalent shares consisted of the following:

	<b>At March 31,</b>	
	<b>2015</b>	<b>2014</b>
Stock options	8,039,498	6,772,555
Warrants	1,000,000	1,000,000

***Comprehensive Loss***

Comprehensive loss is comprised of net loss and other comprehensive income (loss). Other comprehensive income (loss) is comprised of unrealized holding gains and losses arising during the period on available-for-sale securities that are not other-than-temporarily impaired. During the three months ended March 31, 2015, there were no reclassifications out of accumulated other comprehensive income (loss).

***Stock-Based Compensation Expense***

For awards granted to employees and directors, including awards under our Employee Stock Purchase Plan, or ESPP, we measure stock-based compensation cost at the grant date based on the estimated fair value of the award and recognize it as expense over the requisite service period on a straight-line basis. We record the expense of services rendered by non-employees based on the estimated fair value of the stock option as of the respective vesting date. We use the Black-Scholes valuation model in determining the fair value of all equity awards. For awards with performance conditions, we estimate the likelihood of satisfaction of the performance conditions, which affects the period over which the expense is recognized, and recognize the expense over the requisite service period on a straight-line basis. We have no awards with market conditions.

### ***Revenue Recognition***

To date, all of our revenue has been generated under research collaboration agreements. The terms of these research collaboration agreements may include payment to us of non-refundable, upfront license fees, funding or reimbursement of research and development efforts, milestone payments if specified objectives are achieved, and/or royalties on product sales. We evaluate all deliverables within an arrangement to determine whether or not they provide value on a stand-alone basis. Based on this evaluation, the deliverables are separated into units of accounting. For each unit of accounting identified within an arrangement, we determine the

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period over which the performance obligation occurs. Revenue is then recognized using the proportional performance method. The proportional performance method is used when the level of effort to complete the performance obligations under an arrangement can be reasonably estimated. We recognize revenue based upon our best estimate of the selling price for each element when there is no other means to determine the fair value of that item and allocate the consideration based on the relative values. The process for determining the best estimate of the selling price involves significant judgment and estimates.

At the inception of each agreement that includes milestone payments, we evaluate whether each milestone is substantive on the basis of the contingent nature of the milestone. This evaluation includes an assessment of whether:

the consideration is commensurate with either (1) our performance to achieve the milestone, or (2) the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from our performance to achieve the milestone,

the consideration relates solely to past performance, and

the consideration is reasonable relative to all of the deliverables and payment terms within the arrangement.

In making this assessment, we evaluate factors such as the clinical, regulatory, commercial and other risks that must be overcome to achieve the respective milestone, the level of effort and investment required, and whether the milestone consideration is reasonable relative to all deliverables and payment terms in the arrangement. We recognize revenues related to substantive milestones in full in the period in which the substantive milestone is achieved. If a milestone payment is not considered substantive, we recognize the applicable milestone over the remaining period of performance.

We will recognize royalty revenue, if any, based upon actual and estimated net sales by the licensee of licensed products in licensed territories, and in the period the sales occur. We have not recognized any royalty revenue to date.

### ***Research and Development Expense***

Research and development expense consists of expenses incurred in performing research and development activities, including salaries and benefits, overhead expenses including facilities expenses, materials and supplies, preclinical expenses, clinical trial and related clinical manufacturing expenses, comparator drug expenses, stock-based compensation expense, depreciation of equipment, contract services, and other outside expenses. We also include as research and development expense upfront license payments related to acquired technologies which have not yet reached technological feasibility and have no alternative use. We expense research and development costs as they are incurred. Prepaid comparator drug expenses are capitalized and then recognized as expense when title transfers to us. We have been a party to collaboration agreements in which we were reimbursed for work performed on behalf of the collaborator, as well as one in which we reimbursed the collaborator for work it had performed. We record all appropriate expenses under our collaborations as research and development expense. If the arrangement provides for reimbursement of research and development expenses incurred by us, we evaluate the terms of the arrangement to determine whether the reimbursement should be recorded as revenue or as an offset to research and development expense. If the arrangement provides for us to reimburse the collaborator for research and development expenses or for the achievement of a development milestone for which a payment is due, we record the reimbursement or the

achievement of the development milestone as research and development expense.

### ***Income Taxes***

We use the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on temporary differences between financial reporting and income tax basis of assets and liabilities, as well as net operating loss and tax credit carryforwards, and are measured using the enacted tax rates and laws that will be in effect when the differences reverse. Deferred tax assets are reduced by a valuation allowance to reflect the uncertainty associated with their ultimate realization. The effect of a change in tax rate on deferred taxes is recognized in income or loss in the period that includes the enactment date.

We use our judgment for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We recognize any material interest and penalties related to unrecognized tax benefits in income tax expense.

Due to the uncertainty surrounding the realization of the net deferred tax assets in future periods, we have recorded a full valuation allowance against our otherwise recognizable net deferred tax assets as of March 31, 2015 and December 31, 2014.

### ***Fair Value Measurements***

We define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We determine fair value based on the assumptions market participants use when pricing the asset or liability. We also use the fair value hierarchy that prioritizes the information used to develop these assumptions.

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We value our available-for-sale securities utilizing third party pricing services. The pricing services use many observable market inputs to determine value, including benchmark yields, reportable trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, new issue data, monthly payment information and collateral performance. We validate the prices provided by our third party pricing services by understanding the models used, obtaining market values from other pricing sources, and confirming that those securities trade in active markets.

**Property and Equipment**

Property and equipment are stated at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the applicable assets. Assets included in construction-in-progress are not depreciated until placed into service. Application development costs incurred for computer software developed or obtained for internal use are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are eliminated from the respective account, and the resulting gain or loss, if any, is included in current operations. Amortization of leasehold improvements and capital leases is recorded as depreciation expense and included in research and development and general and administrative expense, as applicable. Repairs and maintenance charges that do not increase the useful life of the assets are charged to operations as incurred. Property and equipment are depreciated over the following periods:

Laboratory equipment	5 years
Computer equipment and software	3 to 5 years
Leasehold improvements	Shorter of lease term or useful life of asset
Furniture and fixtures	7 years

**4. Stock-Based Compensation**

Total stock-based compensation expense related to all equity awards for the three months ended March 31, 2015 and 2014 comprised the following:

	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014
	(in thousands)	
<i>Effect of stock-based compensation on net loss by line item:</i>		
Research and development	\$ 2,235	\$ 2,205
General and administrative	1,515	1,539

As of March 31, 2015, we had approximately \$26.7 million of total unrecognized compensation cost, net of estimated forfeitures, related to unvested stock options and awards under our ESPP, which are expected to be recognized over a weighted-average period of 2.7 years.

During the three months ended March 31, 2014, two members of our board of directors retired and were granted the right to exercise their vested stock options for an additional six-month period. In addition, one employee whose employment terminated received an accelerated vesting of his unvested options. In connection with these modifications, we recognized an additional \$0.4 million in stock-based compensation expense during the three months ended March 31, 2014.

*Stock Options*

During the three months ended March 31, 2015, we granted options to purchase 1,643,841 shares of our common stock at a weighted average fair value of \$9.43 and a weighted average exercise price of \$15.56. During the three months ended March 31, 2014, we granted options to purchase 1,152,884 shares of our common stock at a weighted average fair value of \$7.79 and a weighted average exercise price of \$13.13. For the three months ended March 31, 2015 and 2014, the fair values were estimated using the Black-Scholes valuation model using the following weighted-average assumptions:



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	<b>Three Months Ended March 31, 2015</b>	<b>Three Months Ended March 31, 2014</b>
Risk-free interest rate	1.4%	1.7%
Expected annual dividend yield		
Expected stock price volatility	71.5%	71.1%
Expected term of options	5.4 years	5.1 years

During the three months ended March 31, 2015, options to purchase 138,310 shares of common stock were exercised, with a weighted-average exercise price of \$8.40.

*Employee Stock Purchase Plan*

The weighted-average fair value of each purchase right granted during the three months ended March 31, 2015 and 2014 was \$7.62 and \$6.33, respectively. For the three months ended March 31, 2015 and 2014, the fair values were estimated using the Black-Scholes valuation model using the following weighted-average assumptions:

	<b>Three Months Ended March 31, 2015</b>	<b>Three Months Ended March 31, 2014</b>
Risk-free interest rate	0.4%	0.2%
Expected annual dividend yield		
Expected stock price volatility	70.3%	75.21%
Expected term of options	1.2 years	1.2 years

**5. Cash, Cash Equivalents and Available-for-Sale Securities**

The following is a summary of cash, cash equivalents and available-for-sale securities:

	<b>Cost</b>	<b>March 31, 2015 Gross Unrealized Gains</b>		<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
		<b>(in thousands)</b>			
Cash and cash equivalents due in 90 days or less	\$ 223,045	\$	\$		\$ 223,045
Available-for-sale securities:					
Corporate obligations due in one year or less	10,009			(1)	10,008
Mortgage-backed securities due after ten years	397	111			508
<b>Total available-for-sale securities</b>	<b>10,406</b>	<b>111</b>		<b>(1)</b>	<b>10,516</b>
Total cash, cash equivalents and available-for-sale securities	\$ 233,451	\$ 111		\$ (1)	\$ 233,561

Clinical implementation of genomic tests requires robust demonstration of analytic validity, as reported for Afirma in Walsh et al *JCEM* 2012

As many as 30-40% of thyroid carcinomas do not display known somatic oncogene mutations and may harbor novel genetic alterations

The mutation assessment test may serve best as a diagnostic algorithm to identify suspected malignancy with an NPV of up to 95%, Afirma may serve to exclude malignancy

Diagnosis and Management of Differentiated Thyroid Cancer using Molecular Biology(3)(4)

*Laryngoscope*  
(April 2013)

Molecular markers can be classified broadly into those with high positive predictive value (BRAF, RET/PTC, PAX8/PPARc) and those with potentially high negative predictive value (gene expression microarrays)

Gene expression microarrays may eliminate

Molecular markers in the diagnosis of thyroid nodules(1)	<i>Brazilian Archives of Endocrinology and Metabolism</i> (March 2013)	the need for unnecessary diagnostic lobectomy in 60% to 90% of cases
Progress in Molecular-based Management of Differentiated Thyroid Cancer	<i>The Lancet</i> (March 2013)	The Afirma GEC raises specificity on indeterminate cytology thyroid nodules from 0% to 52%, effectively reducing the need to operate by one-half
		The GEC performed best on the atypia of undetermined significance (AUS) or follicular lesion of undetermined significance (FLUS) and follicular neoplasm or suspicious for follicular neoplasm lesions (SFN/SHN) (sensitivity 90%, NPV 94-95%), whereas the NPV was lower for the suspicious for malignancy lesions (85%), which have a higher prevalence of malignancy

- (1) Sponsored by Veracyte and/or co-authored by a Veracyte employee.
- (2) A co-author is a Veracyte consultant and/or member of our clinical advisory board, and owns shares of our common stock.
- (3) Indeterminate results were defined to include any cytological results suspicious for malignancy in addition to UAS/FLUS and SFN/SHN.
- (4) A co-author of this study is a consultant and/or member of our clinical advisory board.

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**Practice Guidelines**

We believe inclusion of new products in practice guidelines is essential to drive their broad adoption and reimbursement. In order to change patient care, tests must carry a high level of published evidence demonstrating clinical validity, analytic validity, clinical utility and cost effectiveness. When studies with such evidence are published in peer-reviewed journals, the authors of practice guidelines may assess the level of evidence and determine whether modifying existing guidelines to include new technology is warranted. In January 2013, the NCCN modified its thyroid cancer guidelines to recommend that physicians consider molecular testing for those patients with cytopathology indeterminate thyroid nodules who have a low risk of cancer. The 2013 NCCN Guidelines further suggest that if a molecular diagnostic test predicts a risk of malignancy comparable to the risk of malignancy of a benign cytopathology result, observation in lieu of a diagnostic surgery is recommended. Based on published evidence, the GEC meets these criteria. Additionally, UpToDate, a leading evidence-based clinical decision support resource for physicians, recommended the GEC in its February 2013 review. We believe our published evidence provides a basis for the American Thyroid Association and the American Association of Clinical Endocrinologists to consider inclusion of the GEC in their treatment guidelines.

**Marketing and Sales**

*Marketing*

Our marketing strategy focuses on the comprehensive nature of the Afirma Thyroid FNA Analysis which includes as its centerpiece our proprietary GEC. Our comprehensive solution reduces the number of unnecessary diagnostic surgeries for patients with thyroid nodules. We believe our solution-based approach differentiates us in the marketplace because we serve as a one-stop provider. Afirma integrates disparate diagnostic procedures into one comprehensive offering, simplifying and improving the diagnostic process for physicians. Our approach can deliver a number of benefits to physicians, payers, and patients, including:

reduction of unnecessary thyroid surgeries;

lower healthcare costs; and

actionable information from a single patient visit.

We employ diverse marketing programs to inform key stakeholders of the value of our solution in order to drive adoption and reimbursement. As part of our marketing strategy, we educate physicians, healthcare professionals and managed care executives about our unique value proposition, which is supported by numerous peer-reviewed publications demonstrating the analytical and clinical validity, clinical utility and cost-effectiveness of Afirma. We primarily achieve this through national and regional clinical meetings focused on thyroid and endocrine disease and disorders. We also sponsor physician speaker programs and continuing medical education where both academic and community physicians educate their peers on the benefits of Afirma. We market to patient advocacy organizations and managed care organizations directly through meetings, phone calls and direct educational efforts. Finally, our website serves as a portal for educational material for healthcare professionals, payers and patients.

*Sales*

Pursuant to our co-promotion agreement with Genzyme, we engage in joint marketing and sales efforts with sales professionals from Genzyme. Our primary target market for Afirma is the approximately 3,500 endocrinologists in the United States whom we believe perform the majority of FNAs in community-based practice settings. We also serve other specialists, including radiologists and ENT physicians who also perform FNAs. To address this concentrated market, we deploy a team of our internal sales professionals and professionals from Genzyme that specialize in endocrinology sales. Our sales team is organized into three regions with 16 territories anticipated by the end of 2014, of which 14 are currently filled. Each

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territory will have a Veracyte sales person complemented by Genzyme sales professionals. We have designed sales goals and financial incentives to align the interests of all sales representatives, regardless of company affiliation, to drive Afirma adoption and growth. Our combined sales team has significant experience selling sophisticated diagnostic services to physicians and deep expertise working with endocrinologists who diagnose and treat patients with thyroid disease and cancer.

We have experienced a high level of customer retention. Of the more than 500 physicians who ordered the Afirma solution in 2011 and 2012 for a minimum of 15 FNAs, nearly 85% continued to order through the end of 2013.

We, together with Genzyme, are in the early stages of commercializing Afirma internationally. We intend to enter select markets in 2014.

**Third-party Relationships**

*Genzyme*

In January 2012, we entered into a co-promotion agreement with Genzyme Corporation, a subsidiary of Sanofi, whereby we granted Genzyme the co-exclusive right to market Afirma in the United States and in 40 countries pursuant to which we received a \$10.0 million up-front fee from Genzyme. Genzyme is an established leader in endocrinology globally, developing and commercializing Thyrogen® (thyrotropin alfa for injection) in over 42 countries worldwide. Thyrogen is an adjunctive diagnostic agent used in follow up of patients with well-differentiated thyroid cancer, and an adjunctive treatment for ablation or destruction of thyroid remnants in patients who have had their thyroid removed for the treatment of well-differentiated thyroid cancer. Afirma offers the Genzyme endocrinology sales force a diagnostic solution that can be promoted as part of a comprehensive solution aimed at improving the quality of care for patients with suspected or confirmed thyroid cancer. We began joint marketing under the agreement in June 2012. We manage the relationship through a steering committee that oversees tactical and strategic planning activities.

Under the agreement, we are required to pay Genzyme a co-promotion fee that is equal to a percentage of our cash receipts from Afirma. As of January 2013, the percentage was 40%, but it decreased to 32% on March 1, 2014 and will remain at that level thereafter. We may receive up to an additional \$3.0 million from Genzyme consisting of \$0.6 million for each country outside of the United States in which we obtain regulatory authorization to market Afirma and achieve a specified level of reimbursement, for up to five countries. Genzyme has also agreed to spend \$0.5 million to support clinical development expenses required for entry into the international markets covered by our agreement. This obligation expires in July 2014. We record the Genzyme co-promotion fees, net of amortization related to the upfront fee, within selling and marketing expense in our statements of operations.

Our agreement with Genzyme expires in January 2027 and either party may terminate the agreement at any time without cause and with six months prior notice. If we terminate the agreement without cause between January 2014 and January 2015, we will be required to repay 40% of the \$10.0 million up-front fee, with such percentage being reduced to 30% of such fee if we were to terminate between January 2015 and January 2016. After January 2016, we are not required to return any portion of the fee if we terminate the agreement without cause. In addition, either party may terminate the agreement upon the occurrence of certain events or cause. We have also granted Genzyme a right of first offer to co-promote any future thyroid cancer product that we commercialize.

*TCP*

We rely on Thyroid Cytopathology Partners, P.A., or TCP, to provide cytopathology professional diagnoses on thyroid FNA samples pursuant to a pathology services agreement. We originally entered into the pathology services agreement in November 2010 with Brazos Valley Pathology, P.A. D/B/A Reitpath,

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which assigned the contract to TCP in May 2011. In December 2012, we further amended the pathology services agreement. Pursuant to the agreement, as amended in full, TCP has the exclusive right to provide the cytopathology diagnoses on FNA samples that are referred to us as part of the Afirma solution at a fixed price per test with volume discounts. TCP can terminate the agreement upon our failure to pay any amounts due under the contract, and either we or TCP can terminate the agreement upon the insolvency of the other party, breach of the agreement by the other party, termination or breach of the service terms or the suspension or termination of the necessary regulatory licenses and approvals needed to perform the FNA diagnoses. TCP is co-located in a portion of our facilities in Austin, Texas and reimburses us for a portion of our actual out-of-pocket rental and related operating expense costs. Our agreement with TCP is effective until December 2015 and thereafter automatically renews every year unless either party provides notice of intent not to renew at least twelve months prior to the end of the then-current term.

**Reimbursement**

Revenue for Afirma comes from several sources, including commercial third-party payers, such as insurance companies and health maintenance organizations, government payers, such as Medicare and Medicaid, and patients.

***Payer Landscape for Afirma***

Reimbursement for Afirma is comprised of two separate components: routine cytopathology and, when cytopathology yields an indeterminate result, reimbursement for the GEC. Substantially all patient samples are assessed with cytopathology for which we bill both the technical and professional component using established CPT codes. We bill payers directly for the GEC using either a unique code or a miscellaneous code. Payers generally assign the GEC its own specific code once a contracting decision is made by the payer.

Effective January 2012, Palmetto GBA, a Medicare administrative contractor, or MAC, with jurisdiction at that time over reimbursement coverage determinations for our products, completed and published an independent technology assessment of Afirma GEC. The review determined that Afirma met criteria for analytical and clinical validity, and clinical utility as a reasonable and necessary Medicare benefit. This coverage decision provided approximately 50 million Medicare participants with access to Afirma. In mid-September 2013, Noridian Administrative Services succeeded Palmetto as the MAC for our region. Noridian continues to reimburse under our unique Z code originally established by Palmetto. On a five year rotational basis, Medicare requests bids for its regional MAC services. Operational changes in contractors processing claims have affected providers in the past, in some cases delaying payment for covered services while claims payment systems are brought on line and fully operational. Changes in the administrative contractor processing Medicare claims for our tests could impact the coverage or payment rates for our current test, could impact our ability to obtain Medicare coverage for products for which we do not yet have coverage or any products we may launch in the future, and may delay payments for our tests.

Collectively, we have more than 120 million lives covered for Afirma, and hundreds of payers have reimbursed one or more GEC tests as of December 2013. We have obtained positive coverage decisions from commercial payers, including UnitedHealthcare in March 2013, Aetna in June 2013, Humana in July 2013 and Cigna in December 2013, as well as several regional payers.

***Dependence on Certain Third-party Payers***

We rely on a small number of third-party payers for a significant portion of our revenue. Reimbursement on behalf of patients covered by Medicare accounted for 32%, 34% and 38% of our revenue for the years ended December 31, 2013, 2012, and 2011, respectively. UnitedHealthcare accounted for 18%, 12% and 13% of our revenue for the years ended December 31, 2013, 2012 and 2011,

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respectively. Aetna accounted for 9%, 13% and 14% of our revenue for the years ended December 31, 2013, 2012 and 2011, respectively. The loss of one or more of these payers would have a negative effect on our business and our revenue.

**Reimbursement Strategy**

We employ a multi-pronged strategy designed to achieve broad coverage and reimbursement for Afirma:

*Meet the evidence standards necessary to be consistent with leading clinical guidelines.* We believe inclusion in leading clinical practice guidelines plays a critical role in payers' coverage decisions. The data published on the GEC to date is consistent with the requirements of the widely-recognized NCCN clinical practice guidelines. We believe that our data provides compelling evidence for inclusion in the American Thyroid Association and the American Association of Clinical Endocrinologists guidelines as well.

*Execute an internal managed care policy and claims adjudication function as part of our core business operations.* We believe that obtaining adequate and widespread reimbursement is a critical factor in our long-term success. We employ a team of in-house claims processing and reimbursement specialists who work with payers, physician practices and patients to obtain maximum reimbursement. In parallel, a managed care team collaborates with our reimbursement specialists to ensure our payer outreach strategy reacts and anticipates the changing needs of our customer base. Our customer service team is an integral part of our reimbursement strategy, working with physician practices and patients to navigate the claims process.

*Cultivate a network of key opinion leaders.* Key opinion leaders are able to influence clinical practice by publishing research and determining whether new tests should be integrated into practice guidelines. We collaborate with key opinion leaders early in the development process to ensure our clinical studies are designed and executed in a way that clearly demonstrates the benefits of our tests to physicians and payers.

*Compile a growing library of peer-reviewed studies that demonstrate the test is effective.* To date, several peer-reviewed articles and review papers have been published and have helped support our efforts aimed at widespread adoption and reimbursement of Afirma. In each disease area we pursue, we intend to conduct studies in order to develop similar supporting literature.

**Our Product Pipeline**

We are continuously evaluating substantial unmet clinical needs in large, addressable markets where we can leverage our molecular cytology platform to commercialize comprehensive solutions that improve quality of life for patients by reducing unnecessary surgeries and costs. Today, minimally invasive cytology biopsies are routinely collected from numerous organs such as breast, cervix, endometrium and others. Similar to thyroid, these often generate ambiguous results that lead to invasive procedures including surgery.

**Afirma Malignancy Classifiers**

Our product development pipeline includes additional molecular cytology tests to complement Afirma that can serve our current customer physician base. We believe we can add value to physicians, payers, and patients by characterizing thyroid nodule FNAs classified as suspicious or malignant by cytopathology with genomic information that determines subclass or suspected malignant diagnosis that could influence the choice of surgery. Several clinical manifestations that may present as a malignant thyroid nodule, such as a recurrent metastatic cancer from another organ or parathyroid conditions, would not be treated by removing the thyroid. Additionally, medullary thyroid cancer, a rare and aggressive form of thyroid cancer, requires a full central neck and lymph node surgery for treatment. Today, many of these remain undiagnosed until thyroid surgery is performed, requiring a second and more invasive surgery. We believe

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the only way to positively affect patient care and costs is to diagnose these conditions from the FNA. Our Afirma Malignancy Classifiers are being developed to inform on surgical strategy using the FNA and to help direct the patient to the right surgery the first time. We intend to introduce this product in the second quarter of 2014, which will expand the number of patients for which we can perform testing using the Afirma solution.

***Idiopathic Pulmonary Fibrosis and Nodules Suspicious for Lung Cancer***

We believe the lung disease market provides several opportunities to expand our molecular cytology platform to improve patient care and reduce costs. We have chosen ILDs as our entry into the lung vertical, as it is a large and often overlooked disease area in need of diagnostics that would meaningfully improve the standard of care. We estimate that over 200,000 patients present each year with an ILD for whom accurate diagnosis is crucial in order to develop optimal treatment plans and accurately communicate prognosis. According to a joint industry statement published in the *American Journal of Respiratory and Critical Care Medicine* in 2011, bronchoscopy, a minimally invasive procedure often used to diagnose lung cancer, is typically inadequate for definitive diagnosis of ILDs. As a result, tens of thousands of patients undergo expensive and invasive surgeries in an effort to obtain a diagnosis. In addition, we estimate over 100,000 patients each year, many of whom would benefit from surgical pathology diagnosis but are not good surgical candidates, are left with ambiguity in their diagnosis, resulting in suboptimal and often harmful treatment. The risks and comorbidities of thoracic surgery to obtain a sample for diagnosis limits the number of patients taken through this diagnostic pathway. However, high resolution CAT scans and clinical history are often not sufficient in order to make a diagnosis. We believe a molecular cytology solution performed on minimally invasive bronchoscopy samples has the potential to inform clinical diagnosis without surgery and to improve the outcomes and lower the cost of care for a significant number of the 200,000 patients suspected of having an ILD, including IPF.

We are in late stage biomarker discovery for IPF, one of the more challenging ILDs to diagnose. Based on promising early results in surgical tissue samples, we have increased the number of clinical sites to 14, including one site in Europe, and we anticipate further site expansion. These sites will accrue clinical bronchoscopy samples to enable the optimization of our classifier based on these samples and will serve as core sites for a prospective, multi-center clinical validation study required prior to targeted commercialization in 2016. We also have early biomarker discovery efforts underway to help resolve the diagnosis of nodules found on imaging modalities that are suspicious for lung cancer.



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Developing new products is a lengthy and complex process, and is subject to numerous risks and uncertainties. We may not be able to commercialize on a timely basis, or at all, products we are developing. If we are not able to do so, our business and our ability to generate revenue could be harmed.

**Research and Development**

Our technology platform offers a number of key attributes:

*Core expertise in whole genome analysis.* Our team of bioinformatics and computational scientists possess extensive knowledge of both existing computational methods as well as the capacity to develop proprietary methods as needed for algorithm design. We demonstrated our ability to make sense of large amounts of genomic data with machine learning algorithms in the development of the GEC.

*Proprietary capabilities in analyzing small, heterogeneous cytology samples.* We have developed proprietary technology, intellectual property and know-how for optimized methods for extraction and analysis of nanogram quantities of RNA from small biopsy samples. Although others can extract RNA from FNAs, we believe their process has not been optimized and scaled for high-throughput clinical testing and large-scale clinical development studies involving amplification and hybridization to high-density microarrays. Our process uses commercially available reagents and instruments with our own proprietary process and protocols, which results in RNA extraction from the range of FNAs used in our clinical development studies and our commercial laboratory test.

*Precision and reproducibility.* We have in place standard operating procedures governing reagents, materials, instruments and controls and extensive experience from numerous verification studies performed for the GEC. We are applying the same high-quality control methods that were developed for our reagents and processes, along with our proprietary software for automation, sample tracking, data quality control and statistical analysis, to our development process in interstitial lung disease and expect to do so for other diseases in the future.

*Technology agnostic discovery platform.* We are not reliant on specific formats and are able to take advantage of a multitude of genomic technologies in developing future tests. When we developed the GEC in 2008, microarray technologies were a cost-effective discovery technology compared to other approaches that were nascent at the time. More recently, the rapid cost reductions achieved in next generation sequencing platforms has allowed us to pursue our whole genome approach to



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biomarker discovery using a range of technologies, including gene expression and DNA methylation, as well as DNA and RNA sequencing.

Our research and development expenses for the years ended December 31, 2013, 2012 and 2011 were \$7.8 million, \$6.6 million and \$6.7 million, respectively.

**Laboratory Operations**

Our laboratory operations are headquartered at our CLIA-certified laboratory in South San Francisco, California, where we perform all GEC testing. Beginning in May 2013, our customers began shipping samples to our CLIA-registered laboratory in Austin, Texas. Once received, samples are processed through our automated accessioning system, prepared for cytopathology review, and delivered to TCP for cytopathology diagnosis. If an FNA sample is diagnosed as indeterminate following cytopathology, the sample is transferred to South San Francisco where we perform GEC testing. Our South San Francisco facility is responsible for quality assurance oversight, licensing and regulation compliance and maintenance for both of our laboratories to ensure data integrity and consistent, validated processes.

We believe we have sufficient laboratory capacity to process Afirma tests, including our planned Afirma Malignancy Classifiers.

**Quality Assurance**

Our quality assurance function oversees the quality of our laboratories as well as the quality systems used in research and development, client services, billing operations and sales and marketing. We have established a quality system implementation and maintenance, document control, supplier qualification, corrective or preventive actions oversight, and employee training processes that we believe achieves excellence in operations across the entire business. We continuously monitor and improve our quality over time and believe our implementation of these processes has supported our achievement of product performance, customer satisfaction and retention and a philosophy of continuous improvement.

**Competition**

We believe the principal competitive factors in our target market include:

quality and strength of clinical and analytical validation data;

confidence in diagnostic results;

the extent of reimbursement;

inclusion in practice guidelines;

cost-effectiveness; and

ease of use.

We believe we compete favorably on the factors described above.

Our principal competition for Afirma comes from traditional methods used by physicians to diagnose thyroid cancer. Practice guidelines in the United States have historically recommended that patients with indeterminate diagnoses from cytopathology results be considered for surgery to remove all or part of the thyroid to rule out cancer. This practice has been the standard of care in the United States, as well as in many international markets, for many years, and we will need to educate physicians about the benefits of our test in order to change clinical practice.



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We also face competition from commercial laboratories, such as Laboratory Corporation of America Holdings and Quest Diagnostics Incorporated, with strong infrastructure to support the commercialization of diagnostic services. We face potential competition from companies, such as Illumina, Inc. and Thermo Fisher Scientific Inc., both of which have announced their intention to enter the clinical diagnostics market. Other potential competitors include companies that develop diagnostic tests such as Roche Diagnostics, a division of Roche Holding Ltd, Siemens AG and Qiagen N.V. We also face competition from Asuragen Inc. and other companies that measure mutational markers such as BRAF and KRAS to identify nodules that are malignant instead of benign. In the future, we may also face competition from companies developing new products or technologies.

In addition, competitors may develop their own versions of our solution in countries where we do not have patents or where our intellectual property rights are not recognized and compete with us in those countries.

Many of our potential competitors have widespread brand recognition and substantially greater financial, technical and research and development resources and selling and marketing capabilities than we do. Others may develop products with prices lower than ours that could be viewed by physicians and payers as functionally equivalent to our solution, or offer solutions at prices designed to promote market penetration, which could force us to lower the list price of our solutions and affect our ability to achieve profitability. If we are unable to change clinical practice in a meaningful way or compete successfully against current and future competitors, we may be unable to increase market acceptance and sales of our products, which could prevent us from increasing our revenue or achieving profitability and could cause our stock price to decline.

**Intellectual Property**

In order to remain competitive, we must develop and maintain protection of the proprietary aspects of our technologies. To that end, we rely on a combination of patents, copyrights and trademarks, as well as contracts, such as confidentiality, invention assignment and licensing agreements. We also rely upon trade secret laws to protect unpatented know-how and continuing technological innovation. In addition, we have what we consider to be reasonable security measures in place to maintain confidentiality. Our intellectual property strategy is intended to develop and maintain our competitive position.

We have seven pending United States nonprovisional patent applications and two patents which expire between 2030 and 2031 related to methods that are used in the Afirma diagnostic and one pending United States provisional patent application relating to our lung disease product under development. Many of these patent applications have also been filed in one or more foreign countries.

We intend to file additional patent applications in the United States and abroad to strengthen our intellectual property rights; however, our patent applications (including the patent applications listed above) may not result in issued patents in a timely fashion or at all, and we cannot assure investors that any patents that have issued or might issue will protect our technology. We may receive notices of claims of potential infringement from third parties in the future.

We hold registered trademarks in the United States for "Veracyte" and "Afirma," and the Veracyte and Afirma logos. We also hold registered trademarks in various jurisdictions outside of the United States.

We require all employees and technical consultants working for us to execute confidentiality agreements, which provide that all confidential information received by them during the course of the employment, consulting or business relationship be kept confidential, except in specified circumstances. Our agreements with our research employees provide that all inventions, discoveries and other types of intellectual property, whether or not patentable or copyrightable, conceived by the individual while he or she is employed by us are assigned to us. We cannot provide any assurance, however, that employees and consultants will abide by the confidentiality or assignment terms of these agreements. Despite measures

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taken to protect our intellectual property, unauthorized parties might copy aspects of our technology or obtain and use information that we regard as proprietary.

**Regulation**

***Clinical Laboratory Improvement Amendments of 1988, or CLIA***

As a clinical reference laboratory, we are required to hold certain federal, state and local licenses, certifications and permits to conduct our business. Under CLIA, we are required to hold a certificate applicable to the type of laboratory examinations we perform and to comply with standards covering personnel, facilities administration, quality systems and proficiency testing.

We have current certificates under CLIA to perform testing at each of our locations. To renew our CLIA certificates, we are subject to survey and inspection every two years to assess compliance with program standards. The regulatory and compliance standards applicable to the testing we perform may change over time, and any such changes could have a material effect on our business.

If one of our clinical reference laboratories is out of compliance with CLIA requirements, we may be subject to sanctions such as suspension, limitation or revocation of our CLIA certificate, as well as directed plan of correction, state on-site monitoring, civil money penalties, civil injunctive suit or criminal penalties. We must maintain CLIA compliance and certification to be eligible to bill for diagnostic services provided to Medicare beneficiaries. If we were to be found out of compliance with CLIA requirements and subjected to sanction, our business could be harmed.

***U.S. Food and Drug Administration: Diagnostic Kits***

Diagnostic kits, including collection systems, that are sold and distributed through interstate commerce are regulated as medical devices by the FDA. Devices subject to FDA regulation must undergo premarket review prior to commercialization unless the device is of a type exempted from such review. In addition, manufacturers of medical devices must comply with various regulatory requirements under the Federal Food, Drug, and Cosmetic Act, or FDC Act, and implementing regulations promulgated under that Act. Entities that fail to comply with FDA requirements may be subject to issuance of notice of observations, untitled or warning letters, and can be liable for criminal or civil penalties, such as recalls, import detentions, seizures, or injunctions, including orders to cease manufacturing.

The FDC Act classifies medical devices into one of three categories based on the risks associated with the device and the level of control necessary to provide reasonable assurance of safety and effectiveness. Class I devices are deemed to be low risk and are subject to the fewest regulatory controls. Many Class I devices are exempt from FDA premarket review requirements. For Class II devices, the FDA generally requires clearance through the premarket notification, or 510(k) clearance, process. Class III devices are generally the highest risk devices and are subject to the highest level of regulatory control to provide reasonable assurance of the device's safety and effectiveness. Class III devices must typically be approved by the FDA before they are marketed.

Generally, establishments that manufacture or distribute devices, including manufacturers, repackagers and relabelers, specification developers, and initial importers, are required to register their establishments with the FDA and provide the FDA a list of the devices that they handle at their facilities.

After a device is placed on the market, numerous regulatory requirements apply. These include: all of the relevant elements of the Quality System Regulation, or QSR, labeling regulations, restrictions on promotion and advertising, the Medical Device Reporting regulation (which requires that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur), and the Reports of Corrections and Removals regulation (which requires manufacturers to report certain recalls and field actions to the FDA).

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The FDA has issued a regulation outlining specific requirements for "specimen transport and storage containers." "Specimen transport and storage containers" are medical devices "intended to contain biological specimens, body waste, or body exudate during storage and transport" so that the specimen can be used effectively for diagnostic examination. A specimen transport and storage container is a Class I device. It is subject to MDR requirements, the reporting of corrections and removals, registration and listing. It is exempt from premarket review and from QSR requirements, except for recordkeeping and complaint handling requirements, so long as no sterility claims are made. Our facility is registered with the FDA as a specification developer, which means that we can sell the collection system under our own name and outline the specifications used to make the collection system, but a third party assembles the collection system for us. The container we provide for collection and transport of FNA samples from a physician to our clinical reference laboratory is listed with the FDA as a Class I medical device and is subject to regulation by the FDA. If the FDA were to determine that our sample collection container is a Class II medical device, we would be required to obtain FDA clearance to use the container.

The FDA enforces the requirements described above by various means, including inspection and market surveillance. If the FDA finds a violation, it can institute a wide variety of enforcement actions, ranging from an Untitled Letter or Warning Letter to more severe sanctions such as:

finances, injunctions, and civil penalties;

recall or seizure of products;

operating restrictions, partial suspension or total shutdown of production; and

criminal prosecution.

***Federal Oversight of Laboratory Developed Tests and Research Use Only Products***

Clinical laboratory tests like Afirma are regulated under CLIA, as administered by the Centers for Medicare & Medicaid Services, or CMS, as well as by applicable state laws. Clinical laboratory tests that are developed and validated by a laboratory for its own use, which are referred to as laboratory developed tests, or LDTs, currently are generally not subject to FDA regulation, although reagents, instruments, software or components provided by third parties and used to perform LDTs may be subject to regulation. We believe that the Afirma GEC is an LDT. As a result, we believe our diagnostic services should not be subject to regulation under established FDA policies. Beginning in 1992, the FDA began expressing its view that all LDTs were subject to FDA regulation as devices; however, it stated that it would generally exercise enforcement discretion and not apply the regulatory requirements for medical devices to LDTs. In June 2010, the FDA announced that it was revisiting its policy of exercising enforcement discretion with respect to LDTs. The FDA held a public meeting in July 2010, and FDA officials subsequently indicated that the FDA is interested in developing a risk-based application of oversight for LDTs and that it plans to issue draft guidance on the regulation of LDTs that would more stringently regulate LDTs that met criteria that would be established by the FDA. In June 2013, FDA Commissioner Margaret A. Hamburg reiterated calls made by other Agency officials for increased FDA oversight of LDTs. Two days later, a laboratory association petitioned the FDA to refrain from issuing any such LDT guidance. Meanwhile, the Food and Drug Administration Safety and Innovation Act requires the FDA to notify Congress at least 60 days prior to issuing a draft or final guidance on the regulation of LDTs. The notice must include anticipated details of the action. Draft guidance has not yet been issued with respect to this proposed oversight of LDTs.

Some products are for research use only, or RUO. An RUO product is not intended for human clinical use and must be labeled "For Research Use Only. Not for use in diagnostic procedures." RUOs are a separate regulatory category and are not considered medical devices. They are therefore not subject to the FDA regulatory requirements discussed above. They cannot make any claims related to safety, effectiveness, or diagnostic utility or be intended for human clinical diagnostic or prognostic use. In

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November 2013, the FDA issued guidance regarding "Commercially Distributed In Vitro Diagnostic Products Labeled for Research Use Only or Investigational Use Only."

We cannot predict the ultimate form or impact of any such RUO, LDT or other guidance and the potential effect on our solutions or materials used to perform our diagnostic services. While we qualify all materials used in our diagnostic services according to CLIA regulations, we cannot be certain that the FDA might not promulgate rules or issue guidance documents that could affect our ability to purchase materials necessary for the performance of our diagnostic services. Should any of the reagents obtained by us from vendors and used in conducting our diagnostic services be affected by future regulatory actions, our business could be adversely affected by those actions, including increasing the cost of service or delaying, limiting or prohibiting the purchase of reagents necessary to perform the service.

We cannot provide any assurance that FDA regulation, including premarket review, will not be required in the future for our diagnostic services, whether through additional guidance or regulations issued by the FDA, new enforcement policies adopted by the FDA or new legislation enacted by Congress. Legislative proposals addressing oversight of LDTs were introduced in recent years, and we expect that new legislative proposals will be introduced from time to time. It is possible that legislation could be enacted into law or regulations or guidance could be issued by the FDA which may result in new or increased regulatory requirements for us to continue to offer our diagnostic services or to develop and introduce new services.

If premarket review, including approval, is required, our business could be negatively affected until such review is completed and clearance to market or approval is obtained, and the FDA could require that we stop selling our diagnostic services pending premarket clearance or approval. If our diagnostic services are allowed to remain on the market but there is uncertainty about the legal status of our services, if we are required by the FDA to label them investigational, or if labeling claims the FDA allows us to make are limited, order levels may decline and reimbursement may be adversely affected. The regulatory process may involve, among other things, successfully completing additional clinical studies and submitting a premarket notification or filing a PMA application with the FDA. If premarket review is required by the FDA, there can be no assurance that our diagnostic services will be cleared or approved on a timely basis, if at all, nor can there any be assurance that labeling claims will be consistent with our current claims or adequate to support continued adoption of and reimbursement for our solution. Ongoing compliance with FDA regulations would increase the cost of conducting our business, and subject us to heightened requirements of the FDA and penalties for failure to comply with these requirements. We may also decide voluntarily to pursue FDA premarket review of our diagnostic services if we determine that doing so would be appropriate.

***Health Insurance Portability and Accountability Act***

Under the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA, the Department of Health and Human Services, or HHS, has issued regulations to protect the privacy and security of protected health information used or disclosed by health care providers, such as us. HIPAA also regulates standardization of data content, codes and formats used in health care transactions and standardization of identifiers for health plans and providers. Penalties for violations of HIPAA regulations include civil and criminal penalties.

We have developed and implemented policies and procedures designed to comply with these regulations. The requirements under these regulations may change periodically and could have an effect on our business operations if compliance becomes substantially more costly than under current requirements.

In addition to federal privacy regulations, there are a number of state laws governing confidentiality of health information that are applicable to our business. The United States Department of Commerce, the European Commission and the Swiss Federal Data Protection and Information Commissioner have agreed



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on a set of data protection principles and frequently asked questions, referred to as the Safe Harbor Principles, to enable U.S. companies to satisfy the requirement under European Union and Swiss law that adequate protection is given to personal information transferred from the European Union or Switzerland to the United States. The European Commission and Switzerland have also recognized the Safe Harbor Principles as providing adequate data protection.

New laws governing privacy may be adopted in the future as well. We have taken steps to comply with health information privacy requirements to which we are aware that we are subject. However, we can provide no assurance that we are or will remain in compliance with diverse privacy requirements in all of the jurisdictions in which we do business. Failure to comply with privacy requirements could result in civil or criminal penalties, which could have a materially adverse effect on our business.

***Federal and State Physician Self-referral Prohibitions***

We are subject to the federal physician self-referral prohibitions, commonly known as the Stark Law, and to similar restrictions under California's Physician Ownership and Referral Act, or PORA. Together these restrictions generally prohibit us from billing a patient or any governmental or private payer for any diagnostic services when the physician ordering the service, or any member of such physician's immediate family, has an investment interest in or compensation arrangement with us, unless the arrangement meets an exception to the prohibition.

Both the Stark Law and PORA contain an exception for compensation paid to a physician for personal services rendered by the physician. We have compensation arrangements with a number of physicians for personal services, such as speaking engagements and consulting activities. We have structured these arrangements with terms intended to comply with the requirements of the personal services exception to Stark and PORA.

However, we cannot be certain that regulators would find these arrangements to be in compliance with Stark, PORA or similar state laws. We would be required to refund any payments we receive pursuant to a referral prohibited by these laws to the patient, the payer or the Medicare program, as applicable.

Sanctions for a violation of the Stark Law include the following:

denial of payment for the services provided in violation of the prohibition;

refunds of amounts collected by an entity in violation of the Stark Law;

a civil penalty of up to \$15,000 for each service arising out of the prohibited referral;

possible exclusion from federal healthcare programs, including Medicare and Medicaid; and

a civil penalty of up to \$100,000 against parties that enter into a scheme to circumvent the Stark Law's prohibition.

These prohibitions apply regardless of the reasons for the financial relationship and the referral. No finding of intent to violate the Stark Law is required for a violation. In addition, knowing violations of the Stark Law may also serve as the basis for liability under the Federal False Claims Act.

Further, a violation of PORA is a misdemeanor and could result in civil penalties and criminal fines. Finally, other states have self-referral restrictions with which we have to comply that differ from those imposed by federal and California law. While we have attempted to comply with the Stark Law, PORA and similar laws of other states, it is possible that some of our financial arrangements with physicians could be subject to regulatory scrutiny at some point in the future, and we cannot provide assurance that we will be found to be in compliance with these laws following any such regulatory review.

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***Federal and State Anti-kickback Laws***

The Federal health care program Anti-kickback Law makes it a felony for a person or entity, including a laboratory, to knowingly and willfully offer, pay, solicit or receive remuneration, directly or indirectly, in order to induce business that is reimbursable under any federal health care program. A violation of the Anti-kickback Law may result in imprisonment for up to five years and fines of up to \$250,000 in the case of individuals and \$500,000 in the case of organizations. Convictions under the Anti-kickback Law result in mandatory exclusion from federal health care programs for a minimum of five years. In addition, HHS has the authority to impose civil assessments and fines and to exclude health care providers and others engaged in prohibited activities from Medicare, Medicaid and other federal health care programs. Actions which violate the Anti-kickback Law also incur liability under the Federal False Claims Act, which prohibits knowingly presenting, or causing to be presented, a false or fraudulent claim for payment to the U.S. Government.

Although the Anti-kickback Law applies only to federal health care programs, a number of states, including California, have passed statutes substantially similar to the Anti-kickback Law pursuant to which similar types of prohibitions are made applicable to all other health plans and third-party payers. Both California's fee-splitting statute, Business and Professions Code Section 650, and its Medi-Cal anti-kickback statute, Welfare and Institutions Code Section 14107.2, have been interpreted by the California Attorney General and California courts in substantially the same way as HHS and the courts have interpreted the Anti-kickback Law. A violation of Section 650 is punishable by imprisonment and fines of up to \$50,000. A violation of Section 14107.2 is punishable by imprisonment and fines of up to \$10,000.

Federal and state law enforcement authorities scrutinize arrangements between health care providers and potential referral sources to ensure that the arrangements are not designed as a mechanism to induce patient care referrals or induce the purchase or prescribing of particular products or services. The law enforcement authorities, the courts and Congress have also demonstrated a willingness to look behind the formalities of a transaction to determine the underlying purpose of payments between health care providers and actual or potential referral sources. Generally, courts have taken a broad interpretation of the scope of the Anti-kickback Law, holding that the statute may be violated if merely one purpose of a payment arrangement is to induce referrals or purchases.

In addition to statutory exceptions to the Anti-kickback Law, regulations provide for a number of safe harbors. If an arrangement meets the provisions of a safe harbor, it is deemed not to violate the Anti-kickback Law. An arrangement must fully comply with each element of an applicable safe harbor in order to qualify for protection. There are no regulatory safe harbors to California's Section 650.

Among the safe harbors that may be relevant to us is the discount safe harbor. The discount safe harbor potentially applies to discounts provided by providers and suppliers, including laboratories, to physicians or institutions. If the terms of the discount safe harbor are met, the discounts will not be considered prohibited remuneration under the Anti-kickback Law. California does not have a discount safe harbor. However, as noted above, Section 650 has generally been interpreted consistent with the Anti-kickback Law.

The personal services safe harbor to the Anti-kickback Law provides that remuneration paid to a referral source for personal services will not violate the Anti-kickback Law provided all of the elements of that safe harbor are met. One element is that if the agreement is intended to provide for the services of the physician on a periodic, sporadic or part-time basis, rather than on a full-time basis for the term of the agreement, the agreement specifies exactly the schedule of such intervals, their precise length, and the exact charge for such intervals. Our personal services arrangements with some physicians may not meet the specific requirement of this safe harbor that the agreement specify exactly the schedule of the intervals of time to be spent on the services because the nature of the services, such as speaking engagements, does not lend itself to exact scheduling and therefore meeting this element of the personal services safe harbor is

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impractical. Failure to meet the terms of the safe harbor does not render an arrangement illegal. Rather, the government may evaluate such arrangements on a case-by-case basis, taking into account all facts and circumstances.

While we believe that we are in compliance with the Anti-kickback Law and Section 650, there can be no assurance that our relationships with physicians, academic institutions and other customers will not be subject to investigation or challenge under such laws. If imposed for any reason, sanctions under the Anti-kickback Law and Section 650 could have a negative effect on our business.

***Other Federal and State Fraud and Abuse Laws***

In addition to the requirements discussed above, several other health care fraud and abuse laws could have an effect on our business. For example, provisions of the Social Security Act permit Medicare and Medicaid to exclude an entity that charges the federal health care programs substantially in excess of its usual charges for its services. The terms "usual charge" and "substantially in excess" are ambiguous and subject to varying interpretations.

Further, the Federal False Claims Act prohibits a person from knowingly submitting a claim, making a false record or statement in order to secure payment or retaining an overpayment by the federal government. In addition to actions initiated by the government itself, the statute authorizes actions to be brought on behalf of the federal government by a private party having knowledge of the alleged fraud. Because the complaint is initially filed under seal, the action may be pending for some time before the defendant is even aware of the action. If the government is ultimately successful in obtaining redress in the matter or if the plaintiff succeeds in obtaining redress without the government's involvement, then the plaintiff will receive a percentage of the recovery. Finally, the Social Security Act includes its own provisions that prohibit the filing of false claims or submitting false statements in order to obtain payment. Violation of these provisions may result in fines, imprisonment or both, and possible exclusion from Medicare or Medicaid programs. California has an analogous state false claims act applicable to all payers, as do many other states; however, we may not be aware of all such rules and statutes and cannot provide assurance that we will be in compliance with all such laws and regulations.

***International***

Many countries in which we may offer Afirma in the future have anti-kickback regulations prohibiting providers from offering, paying, soliciting or receiving remuneration, directly or indirectly, in order to induce business that is reimbursable under any national health care program. In situations involving physicians employed by state-funded institutions or national health care agencies, violation of the local anti-kickback law may also constitute a violation of the United States Foreign Corrupt Practices Act, or FCPA.

The FCPA prohibits any U.S. individual, business entity or employee of a U.S. business entity to offer or provide, directly or through a third party, including any potential distributors we may rely on in certain markets, anything of value to a foreign government official with corrupt intent to influence an award or continuation of business or to gain an unfair advantage, whether or not such conduct violate local laws. In addition, it is illegal for a company that reports to the SEC to have false or inaccurate books or records or to fail to maintain a system of internal accounting controls. We will also be required to maintain accurate information and control over sales and distributors' activities that may fall within the purview of the FCPA, its books and records provisions and its anti-bribery provisions.

The standard of intent and knowledge in the Anti-Bribery cases is minimal intent and knowledge are usually inferred from that fact that bribery took place. The accounting provisions do not require intent. Violations of the FCPA's anti-bribery provisions for corporations and other business entities are subject to a fine of up to \$2 million and officers, directors, stockholders, employees, and agents are subject to a fine of up to \$100,000 and imprisonment for up to five years. Other countries, including the United Kingdom

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and other OECD Anti-Bribery Convention members, have similar anti-corruption regulations, such as the United Kingdom Bribery Act.

When marketing our tests outside of the United States, we may be subject to foreign regulatory requirements governing human clinical testing, prohibitions on the import of tissue necessary for us to perform our tests or restrictions on the export of tissue imposed by countries outside of the United States or the import of tissue into the United States, and marketing approval. These requirements vary by jurisdiction, differ from those in the United States and may in some cases require us to perform additional pre-clinical or clinical testing. In many countries outside of the United States, coverage, pricing and reimbursement approvals are also required.

***California Laboratory Licensing***

In addition to federal certification requirements of laboratories under CLIA, licensure is required and maintained for our South San Francisco clinical reference laboratory under California law. Such laws establish standards for the day-to-day operation of a clinical reference laboratory, including the training and skills required of personnel and quality control. In addition, California laws mandate proficiency testing, which involves testing of specimens that have been specifically prepared for the laboratory.

If our clinical reference laboratory is out of compliance with California standards, the California Department of Health Services, or DHS, may suspend, restrict or revoke our license to operate our clinical reference laboratory, assess substantial civil money penalties, or impose specific corrective action plans. Any such actions could materially affect our business. We maintain a current license in good standing with DHS. However, we cannot provide assurance that DHS will at all times in the future find us to be in compliance with all such laws.

***New York Laboratory Licensing***

Because we receive specimens from New York State, our clinical reference laboratories are required to be licensed by New York, under New York laws and regulations, which establish standards for:

day-to-day operation of a clinical laboratory, including training and skill levels required of laboratory personnel;

physical requirements of a facility;

equipment; and

validation and quality control.

New York law also mandates proficiency testing for laboratories licensed under New York state law, regardless of whether such laboratories are located in New York. If a laboratory is out of compliance with New York statutory or regulatory standards, the New York State Department of Health, or DOH, may suspend, limit, revoke or annul the laboratory's New York license, censure the holder of the license or assess civil money penalties. Statutory or regulatory noncompliance may result in a laboratory's operator being found guilty of a misdemeanor under New York law. DOH also must approve the LDT before the test is offered in New York. Should we be found out of compliance with New York laboratory requirements, we could be subject to such sanctions, which could harm our business. We maintain a current license in good standing with DOH for our South San Francisco and Austin laboratories. We cannot provide assurance that the DOH will at all times find us to be in compliance with applicable laws.

***Other States' Laboratory Licensing***

In addition to New York and California, other states including Florida, Maryland, Pennsylvania and Rhode Island, require licensing of out-of-state laboratories under certain circumstances. We have obtained

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licenses from states where we believe we are required to be licensed, and believe we are in compliance with applicable licensing laws.

From time to time, we may become aware of other states that require out-of-state laboratories to obtain licensure in order to accept specimens from the state, and it is possible that other states do have such requirements or will have such requirements in the future. If we identify any other state with such requirements or if we are contacted by any other state advising us of such requirements, we intend to comply with such requirements.

***Corporate Practice of Medicine***

Numerous states, including California and Texas, have enacted laws prohibiting corporations such as us from practicing medicine and employing or engaging physicians to practice medicine. These laws are designed to prevent interference in the medical decision-making process by anyone who is not a licensed physician. This prohibition is generally referred to as the prohibition against the corporate practice of medicine. Violation of this prohibition may result in civil or criminal fines, as well as sanctions imposed against us or the professional through licensing proceedings. The pathologists who review and classify thyroid FNA cytopathology results for Afirma are employed by Thyroid Cytopathology Partners, a Texas professional association, pursuant to services agreement between us and TCP. Pursuant to the agreement, we pay TCP a monthly fee on a per FNA basis, and TCP manages and supervises the pathologists who perform the cytopathology services as a component of Afirma. TCP is managed by Pathology Resources Consultants, or PRC, which provides management and other services to medical practitioners. We have entered into a services agreement with PRC in connection with our arrangement with TCP, pursuant to which we engaged PRC exclusively to manage the pathology services being provided by TCP. Our agreement with PRC is effective until December 2015 and automatically renews on an annual basis unless either party provides notice of intent not to renew.

**Employees**

At December 31, 2013, we had 115 employees, of which 21 work in laboratory operations, 21 in research and development and clinical development, 18 in selling and marketing, 55 in general and administrative including 30 in billing and client services, eight in information technology, four in human resources, and two in quality and regulatory affairs. None of our employees are the subject of collective bargaining arrangements, and our management considers its relationships with employees to be good.

**Environmental Matters**

Our operations require the use of hazardous materials (including biological materials) which subject us to a variety of federal, state and local environmental and safety laws and regulations. Some of these regulations provide for strict liability, holding a party potentially liable without regard to fault or negligence. We could be held liable for damages and fines as a result of our, or others', business operations should contamination of the environment or individual exposure to hazardous substances occur. We cannot predict how changes in laws or new regulations will affect our business, operations or the cost of compliance.

**Raw Materials and Suppliers**

We procure reagents, equipment, chips and other materials we use to perform the GEC from sole suppliers such as NuGEN Technologies, Inc. and Affymetrix, Inc. We also purchase components used in our Afirma collection kits from sole-source suppliers. Some of these items are unique to these suppliers and vendors. In addition, we utilize a sole source to assemble and distribute our sample collection kits. While we have developed alternate sourcing strategies for these materials and vendors, we cannot be certain whether these strategies will be effective or whether alternative sources will be available when we

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need them. If these suppliers can no longer provide us with the materials we need to perform the GEC and for our collection kits, if the materials do not meet our quality specifications, or if we cannot obtain acceptable substitute materials, our business would be negatively affected.

**Legal Proceedings**

From time to time, we may be party to lawsuits in the ordinary course of business. We are currently not a party to any legal proceedings.

**Available Information**

We were incorporated in Delaware as Calderome, Inc. in August 2006. Calderome operated as an incubator until early 2008. We changed our name to Veracyte, Inc. in March 2008. Our principal executive offices are located at 7000 Shoreline Court, Suite 250, South San Francisco, California 94080 and our telephone number is (650) 243-6300. Our website address is [www.veracyte.com](http://www.veracyte.com). The information contained on, or that can be accessed through, our website is not part of this annual report on Form 10-K.

We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission, or SEC. The reports are also available at [www.sec.gov](http://www.sec.gov).

**ITEM 1A. RISK FACTORS**

**Risks Related to Our Business**

*We are an early-stage company with a history of losses, and we expect to incur net losses for the foreseeable future and may never achieve or sustain profitability.*

We have incurred net losses since our inception. For the years ended December 31, 2013, 2012 and 2011, we had a net loss of \$25.6 million, \$18.6 million and \$14.4 million, respectively, and we expect to incur additional losses in the future. As of December 31, 2013, we had an accumulated deficit of \$85.6 million. To date, we have generated only limited revenue, and we may never achieve revenue sufficient to offset our expenses. Over the next several years, we expect to continue to devote substantially all of our resources to increase adoption of, and reimbursement for, Afirma and to develop future diagnostic solutions. We may never achieve or sustain profitability, and our failure to achieve and sustain profitability in the future could cause the market price of our common stock to decline.

*Our financial results depend solely on sales of Afirma, and we will need to generate sufficient revenue from this and other diagnostic solutions to grow our business.*

All of our historical revenue has been derived from the sale of Afirma, which we commercially launched in January 2011. For the foreseeable future, we expect to derive substantially all of our revenue from sales of Afirma. We are in various stages of research and development for other diagnostic solutions that we may offer, but there can be no assurance that we will be able to identify other diseases that can be effectively addressed with our molecular cytology platform or, if we are able to identify such diseases, whether or when we will be able to successfully commercialize these solutions. If we are unable to increase sales of Afirma, expand reimbursement for Afirma, or successfully develop and commercialize other solutions, our revenue and our ability to achieve and sustain profitability would be impaired, and the market price of our common stock could decline.

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***We depend on Medicare, Aetna and UnitedHealthcare for a significant portion of our revenue and if one or more significant payers stop providing reimbursement or decrease the amount of reimbursement for our tests, our revenue could decline.***

Reimbursement on behalf of patients covered by Medicare accounted for 32%, 34% and 38% of our revenue for the years ended December 31, 2013, 2012 and 2011, respectively. UnitedHealthcare accounted for 18%, 12% and 13% of our revenue for the years ended December 31, 2013, 2012 and 2011, respectively. Aetna accounted for 13% and 14% of our revenue for the years ended December 31, 2012 and 2011, respectively. Effective January 2012, Palmetto GBA, the regional Medicare administrative contractor, or MAC, that handled claims processing for Medicare services with jurisdiction at that time, issued coverage and payment determinations on the GEC. On a five-year rotational basis, Medicare requests bids for its regional MAC services. In mid-September 2013, Noridian Administrative Services succeeded Palmetto as the MAC for our region. We believe the transition is complete with claims being processed by Noridian using the Z code established by Palmetto at the prior negotiated pricing level. This change, or any future changes, in the MAC processing Medicare claims for the GEC could result in a change in the coverage or reimbursement rates for the GEC, or the loss of coverage. In addition, the transition to Noridian has resulted in some delays in payments made to us on behalf of Medicare patients and a slower payment cycle in general.

We do not have a contracted rate of reimbursement with Aetna, Cigna, Humana or UnitedHealthcare. Payers may suspend or discontinue reimbursement at any time, may require or increase co-payments from patients, or may reduce the reimbursement rates paid to us. Any such actions could have a negative effect on our revenue.

***If payers do not provide reimbursement, rescind or modify their reimbursement policies or delay payments for our tests, or if we are unable to successfully negotiate reimbursement contracts, our commercial success could be compromised.***

Physicians may not order our tests unless payers reimburse a substantial portion of the test price. There is significant uncertainty concerning third-party reimbursement of any test incorporating new technology, including the GEC. Reimbursement by a payer may depend on a number of factors, including a payer's determination that tests such as the GEC are:

- not experimental or investigational;
- appropriate for the specific patient;
- cost-effective;
- supported by peer-reviewed publications; and
- included in clinical practice guidelines.

Since each payer makes its own decision as to whether to establish a policy or enter into a contract to reimburse our test, seeking these approvals is a time-consuming and costly process.

We do not have a contracted rate of reimbursement with most payers. Without a contracted rate for reimbursement, our claims are often denied upon submission, and we must appeal the claims. The appeals process is time consuming and expensive, and may not result in payment. In cases where there is not a contracted rate for reimbursement, there is typically a greater patient co-insurance or co-payment requirement which may result in further delay or decreased likelihood of collection.

We expect to continue to focus substantial resources on increasing adoption of and coverage and reimbursement for Afirma. We believe it may take several years to achieve coverage and contracted reimbursement with a majority of third-party payers. However, we cannot predict whether, under what circumstances, or at what payment levels payers will reimburse for our test. In addition, the planned launch

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of our Afirma Malignancy Classifiers and any other new products we may develop in the future may require that we expend substantial time and resources in order to obtain reimbursement. If we fail to establish broad adoption of and reimbursement for our products, or if we are unable to maintain existing reimbursement from payers, our ability to generate revenue could be harmed and our future prospects and our business could suffer.

***We may experience limits on our revenue if physicians decide not to order Afirma.***

If we are unable to create or maintain demand for Afirma in sufficient volume, we may not become profitable. To generate demand, we will need to continue to educate physicians about the benefits and cost-effectiveness of Afirma through published papers, presentations at scientific conferences and one-on-one education by our sales force. In addition, our ability to obtain and maintain adequate reimbursement from third-party payers will be critical to generating revenue.

Several existing guidelines and historical practices in the United States regarding indeterminate thyroid nodule FNA results recommend a full or partial surgical thyroidectomy in most cases. Accordingly, physicians may be reluctant to order a diagnostic solution that may suggest surgery is unnecessary where several current guidelines and historical practice have typically led to such procedures. Moreover, our diagnostic services are performed at our clinical reference laboratory rather than by a pathologist in a local laboratory, so pathologists may be reluctant to support our services. In addition, guidelines for the diagnosis and treatment of thyroid nodules may subsequently be revised to recommend another type of treatment protocol, and these changes may result in medical practitioners deciding not to use Afirma. These facts may make physicians reluctant to convert to using Afirma, which could limit our ability to generate revenue and our ability to achieve profitability. To the extent international markets have existing practices and standards of care that are different than those in the United States, we may face challenges with the adoption of Afirma outside the United States.

***The success of our relationship with Genzyme to co-promote Afirma may have a significant effect on our business.***

We sell Afirma in the United States through our internal sales team and through our co-promotion agreement with Genzyme Corporation. We are also working with Genzyme to begin selling Afirma in certain countries outside of the United States. Under the agreement, we are required to pay Genzyme a co-promotion fee that is equal to a percentage of our cash receipts from Afirma. The percentage was 40% and decreased to 32% on March 1, 2014 and will remain at this level thereafter. Our agreement with Genzyme expires in 2027 and either party may terminate the agreement at any time without cause and with six months prior notice. If we were to terminate the agreement without cause prior to January 2015, we would be required to repay 40% of the \$10.0 million fee we received from Genzyme. Such percentage would be reduced to 30% of such fee if we were to terminate the agreement between January 2015 and January 2016. We have also granted Genzyme a right of first offer to co-promote any future thyroid cancer product that we commercialize. If Genzyme does not commit the necessary resources to market and sell Afirma to the level of our expectations, or if they terminate the agreement, we may not realize the benefits of this relationship, and our ability to generate revenue in the future may be harmed. If our agreement with Genzyme were terminated, we would have to hire additional sales personnel to support the growth of Afirma and any other thyroid product we agree to co-promote with Genzyme. Any such termination may also delay our entry into international markets.

***Because we do not recognize a significant portion of our revenue on an accrual basis, our quarterly operating results are likely to fluctuate.***

We currently recognize the majority of our revenue upon the earlier of receipt of third-party payer notification of payment or when cash is received. We have little visibility as to when we will receive payment for our diagnostic test, and we must appeal negative payment decisions, which delays collections. These factors will likely result in fluctuations in our quarterly revenue. As a result, comparing our



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operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. In addition, these fluctuations in revenue may make it difficult for us, research analysts and investors to accurately forecast our revenue and operating results. If our revenue or operating results fall below expectations, the price of our common stock would likely decline.

***We rely on sole suppliers for some of the reagents, equipment, chips and other materials used in Afirma, and we may not be able to find replacements or transition to alternative suppliers.***

We rely on sole suppliers, such as NuGEN Technologies, Inc. and Affymetrix, Inc., for critical supply of reagents, equipment, chips and other materials that we use to perform the GEC. We also purchase components used in our Afirma collection kits from sole-source suppliers. Some of these items are unique to these suppliers and vendors. In addition, we utilize a sole source to assemble and distribute our sample collection kits. While we have developed alternate sourcing strategies for these materials and vendors, we cannot be certain whether these strategies will be effective or the alternative sources will be available when we need them. If these suppliers can no longer provide us with the materials we need to perform the GEC and for our collection kits, if the materials do not meet our quality specifications, or if we cannot obtain acceptable substitute materials, an interruption in test processing could occur and we may not be able to deliver patient reports. Any such interruption may significantly affect our future revenue, cause us to incur higher costs, and harm our customer relations and reputation. In addition, in order to mitigate these risks, we may need to maintain inventories of these supplies at higher levels than would be the case if multiple sources of supply were available.

***We depend on a specialized cytopathology practice to perform the cytopathology component of Afirma, and our ability to perform our diagnostic solution would be harmed if we were required to secure a replacement.***

We rely on Thyroid Cytopathology Partners, P.A., or TCP, to provide cytopathology professional diagnoses on thyroid FNA samples pursuant to a pathology services agreement. Pursuant to this agreement, TCP has the exclusive right to provide the cytopathology diagnoses on FNA samples at a fixed price per test. We have also agreed to allow TCP to co-locate in a portion of our facilities in Austin, Texas. Our agreement with TCP is effective until December 2015 and thereafter automatically renews every year unless either party provides notice of intent not to renew at least twelve months prior to the end of the then-current term.

If TCP were not able to support our current test volume or future increases in test volume or to provide the quality of services we require, or if we are unable to agree on commercial terms and our relationship with TCP were to terminate, our business would be harmed until we are able to secure the services of another cytopathology provider. There can be no assurance that we would be successful in finding a replacement that would be able to conduct cytopathology diagnoses at the same volume or with the same high-quality results as TCP. Locating another suitable cytopathology provider could be time consuming and would result in delays in processing tests until a replacement was fully integrated with our test processing operations.

***If we are unable to support demand for Afirma or any of our future products or solutions, our business could suffer.***

As demand for Afirma or any of our future products or solutions grows, we will need to continue to scale our testing capacity and processing technology, expand customer service, billing and systems processes and enhance our internal quality assurance program. We will also need additional certified laboratory scientists and other scientific and technical personnel to process higher volumes of our tests. We cannot assure you that any increases in scale, related improvements and quality assurance will be successfully implemented or that appropriate personnel will be available. Failure to implement necessary procedures, transition to new processes or hire the necessary personnel could result in higher costs of processing tests or inability to meet demand. There can be no assurance that we will be able to perform our

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testing on a timely basis at a level consistent with demand, or that our efforts to scale our operations will not negatively affect the quality of test results. If we encounter difficulty meeting market demand or quality standards, our reputation could be harmed and our future prospects and our business could suffer.

***If the FDA were to begin regulating our tests, we could incur substantial costs and delays associated with trying to obtain premarket clearance or approval.***

Clinical laboratory tests like Afirma are regulated under the Clinical Laboratory Improvement Amendments of 1988, or CLIA, as well as by applicable state laws. Most laboratory developed tests, or LDTs, are not currently subject to FDA regulation, although reagents, instruments, software or components provided by third parties and used to perform LDTs may be subject to regulation. Although the FDA has never defined what qualifies as an LDT, we believe that Afirma is an LDT. As a result, we believe Afirma should not be subject to regulation in accordance with the FDA's current policy of exercising enforcement discretion regarding LDTs.

From time to time, the FDA has indicated that it was revisiting its current policy of enforcement discretion and planned to issue guidance that, when finalized, would adopt a risk-based framework that would increase FDA oversight of LDTs. In July 2010, the FDA convened a public meeting to discuss such a risk-based framework. Legislative proposals addressing oversight of LDTs were introduced in the previous two Congresses and we expect that new legislative proposals will be introduced from time to time. We cannot provide any assurance that FDA regulation, including premarket review, will not be required in the future for our tests, whether through additional guidance or regulations issued by the FDA, new enforcement policies adopted by the FDA or new legislation enacted by Congress. It is possible that legislation will be enacted into law, regulations could be promulgated or guidance could be issued by the FDA which may result in increased regulatory burdens for us to continue to offer our tests or to develop and introduce new tests. We cannot predict the timing or content of future legislation enacted, regulations promulgated or guidance issued regarding LDTs, or how it will affect our business.

If FDA premarket review, including approval, is required for Afirma or any of our future tests we may develop, or we decide to voluntarily pursue FDA approval, we may be forced to stop selling our tests or we may be allowed to keep selling our tests while we work to obtain FDA approval. Our business would be negatively affected until such review is completed and clearance to market or approval is obtained. The regulatory process may involve, among other things, successfully completing additional clinical studies and submitting premarket notification or filing a premarket approval application with the FDA. If premarket review is required by the FDA or if we decide to voluntarily pursue FDA premarket review of our tests, there can be no assurance that Afirma or any tests we may develop in the future will be cleared or approved on a timely basis, if at all, nor can there be assurance that labeling claims will be consistent with our current claims or adequate to support continued adoption of and reimbursement for our tests. If our tests are allowed to remain on the market but there is uncertainty in the marketplace about our tests, if we are required by the FDA to label them investigational, or if labeling claims the FDA allows us to make are limited, orders may decline and reimbursement may be adversely affected. Ongoing compliance with FDA regulations would increase the cost of conducting our business, and subject us to heightened regulation by the FDA and penalties for failure to comply with these requirements.

Some of the materials we use for Afirma are labeled for research use only. In June 2011, the FDA issued draft guidance regarding "Commercially Distributed In Vitro Diagnostic Products Labeled for Research Use Only or Investigational Use Only." To date, the FDA has not issued final research-use only guidance. We cannot predict the ultimate timing or form of any such guidance or regulation and or the potential effect on Afirma, our tests in development or the materials used to perform our tests. While we qualify all materials used in our tests according to CLIA regulations, we cannot be certain that the FDA would not promulgate rules or issue guidance documents that could affect our ability to purchase materials necessary for the performance of our tests. Should any of the reagents, instruments, software or components obtained by us from suppliers and used in conducting our tests be affected by future

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regulatory actions, our business could be adversely affected by those actions, including increasing the cost of testing or delaying, limiting or prohibiting the purchase of reagents, instruments, software or components necessary to perform testing.

In addition, our sample collection container is classified as a Class I medical device and is listed with the FDA. If the FDA was to determine that it is a Class II medical device, we would be required to file a 510(k) application and obtain FDA clearance to use the container, which could be time consuming and expensive.

***We may be unable to manage our future growth effectively, which could make it difficult to execute our business strategy.***

In addition to the need to scale our testing capacity, future growth will impose significant added responsibilities on management, including the need to identify, recruit, train and integrate additional employees. In addition, rapid and significant growth may place strain on our administrative and operational infrastructure. Our ability to manage our business and growth will require us to continue to improve our operational, financial and management controls, reporting systems and procedures. We have only recently installed a new, internally developed data warehouse, which is critical to our ability to track our diagnostic services and patient reports delivered to physicians, as well as to support our financial reporting systems. The time and resources required to optimize these systems is uncertain, and failure to complete optimization in a timely and efficient manner could adversely affect our operations. If we are unable to manage our growth effectively, it may be difficult for us to execute our business strategy and our business could be harmed.

***Billing for our diagnostic solution is complex, and we must dedicate substantial time and resources to the billing process to be paid for our tests.***

Billing for clinical laboratory testing services is complex, time consuming and expensive. Depending on the billing arrangement and applicable law, we bill various payers, including Medicare, insurance companies and patients, all of which have different billing requirements. We generally bill third-party payers for our diagnostic solution and pursue reimbursement on a case-by-case basis where pricing contracts are not in place. To the extent laws or contracts require us to bill patient co-payments or co-insurance, we must also comply with these requirements. We may also face increased risk in our collection efforts, including potential write-offs of doubtful accounts and long collection cycles, which could adversely affect our business, results of operations and financial condition.

Several factors make the billing process complex, including:

differences between the list price for Afirma and the reimbursement rates of payers;

compliance with complex federal and state regulations related to billing Medicare;

disputes among payers as to which party is responsible for payment;

differences in coverage among payers and the effect of patient co-payments or co-insurance;

differences in information and billing requirements among payers;

incorrect or missing billing information; and

the resources required to manage the billing and claims appeals process.

As we introduce new tests, such as the Afirma Malignancy Classifiers, we will need to add new codes to our billing process as well as our financial reporting systems. Failure or delays in effecting these changes in external billing and internal systems and processes could negatively affect our revenue and cash flow.



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Additionally, our billing activities require us to implement compliance procedures and oversight, train and monitor our employees, challenge coverage and payment denials, assist patients in appealing claims, and undertake internal audits to evaluate compliance with applicable laws and regulations as well as internal compliance policies and procedures. Payers also conduct external audits to evaluate payments, which add further complexity to the billing process. These billing complexities, and the related uncertainty in obtaining payment for our diagnostic solution, could negatively affect our revenue and cash flow, our ability to achieve profitability, and the consistency and comparability of our results of operations.

*We rely on a third-party to transmit claims to payers, and any delay in transmitting claims could have an adverse effect on our revenue.*

While we manage the overall processing of claims, we rely on a third-party provider to transmit the actual claims to payers based on the specific payer billing format. We have previously experienced delays in claims processing when our third-party provider made changes to its invoicing system, and again when it did not submit claims to payers within the timeframe we require. If claims for Afirma are not submitted to payers on a timely basis, or if we are required to switch to a different provider to handle claim submissions, we may experience delays in our ability to process these claims and receipt of payments from payers, which would have an adverse effect on our revenue and our business.

*International expansion of our business exposes us to business, regulatory, political, operational, financial and economic risks associated with doing business outside of the United States.*

Our business strategy includes international expansion, primarily through our co-promotion agreement with Genzyme, and may include developing and maintaining physician outreach and education capabilities outside of the United States, establishing agreements with laboratories, and expanding our relationships with international payers. Doing business internationally involves a number of risks, including:

multiple, conflicting and changing laws and regulations such as tax laws, privacy laws, export and import restrictions, employment laws, regulatory requirements and other governmental approvals, permits and licenses;

failure by us to obtain regulatory approvals where required for the use of our solution in various countries;

complexities associated with managing multiple payer reimbursement regimes, government payers or patient self-pay systems;

logistics and regulations associated with shipping tissue samples, including infrastructure conditions and transportation delays;

challenges associated with establishing laboratory partners, including proper sample collection techniques, inventory management, sample logistics, billing and promotional activities;

limits on our ability to penetrate international markets if we are not able to process tests locally;

financial risks, such as longer payment cycles, difficulty in collecting from payers, the effect of local and regional financial crises, and exposure to foreign currency exchange rate fluctuations;

natural disasters, political and economic instability, including wars, terrorism, and political unrest, outbreak of disease, boycotts, curtailment of trade and other business restrictions; and

regulatory and compliance risks that relate to maintaining accurate information and control over activities that may fall within the purview of the Foreign Corrupt Practices Act of 1977, its books and records provisions or its anti-bribery provisions.



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Any of these factors could significantly harm our future international expansion and operations and, consequently, our revenue and results of operations.

***If we are unable to compete successfully, we may be unable to increase or sustain our revenue or achieve profitability.***

Our principal competition for Afirma comes from traditional methods used by physicians to diagnose thyroid cancer. Practice guidelines in the United States have historically recommended that patients with indeterminate diagnoses from cytopathology results be considered for surgery to remove all or part of the thyroid to rule out cancer. This practice has been the standard of care in the United States for many years, and we need to educate physicians about the benefits of Afirma to change clinical practice.

We also face competition from commercial laboratories, such as Laboratory Corporation of America Holdings and Quest Diagnostics Incorporated, with strong infrastructure to support the commercialization of diagnostic services. We face potential competition from companies such as Illumina, Inc. and Thermo Fisher Scientific Inc., both of which have announced their intention to enter the clinical diagnostics market. Other potential competitors include companies that develop diagnostic products, such as Roche Diagnostics, a division of Roche Holding Ltd, Siemens AG and Qiagen N.V. We also face competition from Asuragen Inc. and other companies that measure mutational markers such as BRAF and KRAS to identify nodules that are malignant instead of benign. In the future, we may also face competition from companies developing new products or technologies.

In addition, competitors may develop their own versions of our solution in countries where we do not have patents or where our intellectual property rights are not recognized and compete with us in those countries, including encouraging the use of their solution by physicians in other countries.

To compete successfully we must be able to demonstrate, among other things, that our diagnostic test results are accurate and cost effective, and we must secure a meaningful level of reimbursement for our products.

Many of our potential competitors have widespread brand recognition and substantially greater financial, technical and research and development resources and selling and marketing capabilities than we do. Others may develop products with prices lower than ours that could be viewed by physicians and payers as functionally equivalent to our solution, or offer solutions at prices designed to promote market penetration, which could force us to lower the list price of our solution and affect our ability to achieve profitability. If we are unable to change clinical practice in a meaningful way or compete successfully against current and future competitors, we may be unable to increase market acceptance and sales of our products, which could prevent us from increasing our revenue or achieving profitability and could cause the market price of our common stock to decline.

***Developing new products involves a lengthy and complex process, and we may not be able to commercialize on a timely basis, or at all, other products we are developing.***

We have enhancements to our current Afirma offering and other diagnostic solutions under development that will require us to devote considerable resources to research and development. There can be no assurance that we will be able to identify other diseases that can be effectively addressed with our molecular cytology platform. In addition, if we identify such diseases, we may not be able to develop products with the diagnostic accuracy necessary to be clinically useful and commercially successful. We are in the process of developing Afirma Malignancy Classifiers and a product for interstitial lung disease. These products may not be fully developed and introduced as planned in the second quarter of 2014 and in 2016, respectively. In the longer term, we may face challenges obtaining sufficient numbers of samples to validate a genomic signature for a molecular diagnostic product. In order to develop and commercialize diagnostic products, we need to:

expend significant funds to conduct substantial research and development;

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conduct successful analytical and clinical studies;

scale our laboratory processes to accommodate new tests; and

build the commercial infrastructure to market and sell new products.

Our product development process involves a high degree of risk and may take several years. Our product development efforts may fail for many reasons, including:

failure to identify a genomic signature in biomarker discovery;

inability to secure sufficient numbers of samples at an acceptable cost and on an acceptable timeframe to conduct analytical and clinical studies; or

failure of clinical validation studies to support the effectiveness of the test.

Typically, few research and development projects result in commercial products, and success in early clinical studies often is not replicated in later studies. At any point, we may abandon development of a product candidate or we may be required to expend considerable resources repeating clinical studies, which would adversely affect the timing for generating potential revenue from a new product and our ability to invest in other products in our pipeline. If a clinical validation study fails to demonstrate the prospectively defined endpoints of the study or if we fail to sufficiently demonstrate analytical validity, we might choose to abandon the development of the product, which could harm our business. In addition, competitors may develop and commercialize competing products or technologies faster than us or at a lower cost.

***We may acquire businesses or assets, form joint ventures or make investments in other companies or technologies that could harm our operating results, dilute our stockholders' ownership, increase our debt or cause us to incur significant expense.***

As part of our business strategy, we may pursue acquisitions of complementary businesses or assets, as well as technology licensing arrangements. We also may pursue strategic alliances that leverage our core technology and industry experience to expand our offerings or distribution, or make investments in other companies. To date, we have not acquired other companies and have limited experience with respect to the formation of strategic alliances and joint ventures. If we make any acquisitions, we may not be able to integrate these acquisitions successfully into our existing business, and we could assume unknown or contingent liabilities. Any future acquisitions by us also could result in significant write-offs or the incurrence of debt and contingent liabilities, any of which could harm our operating results. Integration of an acquired company or business also may require management resources that otherwise would be available for ongoing development of our existing business. We may not identify or complete these transactions in a timely manner, on a cost-effective basis, or at all, and we may not realize the anticipated benefits of any acquisition, technology license, strategic alliance, joint venture or investment.

To finance any acquisitions or investments, we may choose to issue shares of our stock as consideration, which would dilute the ownership of our stockholders. If the price of our common stock is low or volatile, we may not be able to acquire other companies for stock. Alternatively, it may be necessary for us to raise additional funds for these activities through public or private financings. Additional funds may not be available on terms that are favorable to us, or at all. If these funds are raised through the sale of equity or convertible debt securities, dilution to our stockholders could result. Our current loan and security agreement contains covenants that could limit our ability to sell debt securities or obtain additional debt financing arrangements.



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***If we are unable to develop products to keep pace with rapid technological, medical and scientific change, our operating results and competitive position could be harmed.***

In recent years, there have been numerous advances in technologies relating to diagnostics, particularly diagnostics that are based on genomic information. These advances require us to continuously develop our technology and to work to develop new solutions to keep pace with evolving standards of care. Our solutions could become obsolete unless we continually innovate and expand our product offerings to include new clinical applications. If we are unable to develop new products or to demonstrate the applicability of our products for other diseases, our sales could decline and our competitive position could be harmed.

***If we fail to comply with federal, state and foreign laboratory licensing requirements, we could lose the ability to perform our tests or experience disruptions to our business.***

We are subject to CLIA, a federal law that regulates clinical laboratories that perform testing on specimens derived from humans for the purpose of providing information for the diagnosis, prevention or treatment of disease. CLIA regulations mandate specific standards in the areas of personnel qualifications, administration, and participation in proficiency testing, patient test management and quality assurance. CLIA certification is also required in order for us to be eligible to bill state and federal healthcare programs, as well as many private third-party payers, for Afirma. To renew these certifications, we are subject to survey and inspection every two years. Moreover, CLIA inspectors may make random inspections of our clinical reference laboratories.

We are also required to maintain state licenses to conduct testing in our laboratories. California law requires that we maintain a license and establishes standards for the day-to-day operation of our clinical reference laboratory in South San Francisco, including the training and skills required of personnel and quality control matters. In addition, both of our clinical reference laboratories are required to be licensed on a test-specific basis by New York State. New York law also mandates proficiency testing for laboratories licensed under New York state law, regardless of whether such laboratories are located in New York. Several other states require that we hold licenses to test samples from patients in those states. Other states may have similar requirements or may adopt similar requirements in the future. If we were to lose our CLIA certificate or California license for our South San Francisco laboratory, whether as a result of revocation, suspension or limitation, we would no longer be able to perform the GEC, which would eliminate our primary source of revenue and harm our business. If we were to lose our CLIA certificate for our Austin laboratory, we would need to move the receipt and storage of FNAs, as well as the slide preparation for cytopathology, to South San Francisco, which could result in a delay in processing tests during that transition and increased costs. If we were to lose our licenses issued by New York or by other states where we are required to hold licenses, we would not be able to test specimens from those states.

Finally, we may be subject to regulation in foreign jurisdictions as we pursue offering Afirma internationally. Other limitations, such as prohibitions on the import of tissue necessary for us to perform our tests or restrictions on the export of tissue imposed by countries outside of the United States or the import of tissue into the United States, may limit our ability to offer Afirma internationally in the future.

***Changes in healthcare policy, including legislation reforming the U.S. healthcare system, may have a material adverse effect on our financial condition and operations.***

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act, collectively, the PPACA, enacted in March 2010, makes changes that are expected to significantly affect the pharmaceutical and medical device industries and clinical laboratories. Beginning in 2013, each medical device manufacturer must pay a sales tax in an amount equal to 2.3% of the price for which such manufacturer sells its medical devices that are listed with the FDA. The FDA has asserted that clinical laboratory tests such as Afirma are medical devices. However, consistent with the

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FDA's policy of exercising enforcement discretion for LDTs, Afirma is not currently listed as a medical device with the FDA. We cannot assure you that the tax will not be extended to services such as ours in the future if Afirma were to be regulated as a device. The PPACA also mandates a reduction in payments for clinical laboratory services paid under the Medicare Clinical Laboratory Fee Schedule, or CLFS, of 1.75% for the years 2011 through 2015 and a productivity adjustment to the CLFS which would affect our cytopathology billings.

Other significant measures contained in the PPACA include, for example, coordination and promotion of research on comparative clinical effectiveness of different technologies and procedures, initiatives to revise Medicare payment methodologies, such as bundling of payments across the continuum of care by providers and physicians, and initiatives to promote quality indicators in payment methodologies. The PPACA also includes significant new fraud and abuse measures, including required disclosures of financial arrangements with physician customers, lower thresholds for violations and increasing potential penalties for such violations. In addition, the PPACA establishes an Independent Payment Advisory Board, or IPAB, to reduce the per capita rate of growth in Medicare spending. The IPAB has broad discretion to propose policies to reduce expenditures, which may have a negative effect on payment rates for services. The IPAB proposals may affect payments for clinical laboratory services beginning in 2016 and for hospital services beginning in 2020. We are monitoring the effect of the PPACA to determine the trends and changes that may be necessitated by the legislation, any of which may potentially affect our business.

In addition to the PPACA, the effect of which on our business cannot presently be fully quantified, various healthcare reform proposals have also emerged from federal and state governments. For example, in February 2012, Congress passed the Middle Class Tax Relief and Job Creation Act of 2012, which in part resets the clinical lab payment rates on the Medicare CLFS by 2% in 2013. In addition, a further reduction of 2% is anticipated from implementation of the automatic expense reductions (sequester) under the Budget Control Act of 2011, which is legislated to be in effect for dates of service on or after April 1, 2013 until fiscal year 2024. Reductions resulting from the Congressional sequester are applied to total claims payment made; however, they do not currently result in a rebasing of the negotiated or established Medicare or Medicaid reimbursement rates.

State legislation on reimbursement applies to Medicaid reimbursement and Managed Medicaid reimbursement rates within that state. Some states have passed or proposed legislation that would revise reimbursement methodology for clinical laboratory payment rates under those Medicaid programs. Recent changes to reimbursement methodologies have not changed the payment rate for Afirma; however, we cannot predict whether future healthcare initiatives will be implemented at the federal or state level or in countries outside of the United States in which we may do business, or the effect any future legislation or regulation will have on us. The taxes imposed by the new federal legislation, cost reduction measures and the expansion in the role of the U.S. government in the healthcare industry may result in decreased revenue, lower reimbursement by payers for our tests or reduced medical procedure volumes, all of which may adversely affect our business, financial condition and results of operations. In addition, sales of our tests outside the United States will subject our business to foreign regulatory requirements and cost-reduction measures, which may also change over time.

Ongoing calls for deficit reduction at the Federal government level and reforms to programs such as the Medicare program to pay for such reductions may affect the pharmaceutical, medical device and clinical laboratory industries. In particular, recommendations by the Simpson-Bowles Commission called for the combination of Medicare Part A (hospital insurance) and Part B (physician and ancillary service insurance) into a single co-insurance and co-payment structure. Currently, clinical laboratory services are excluded from the Medicare Part B co-insurance and co-payment as preventative services. Combining Parts A and B may require clinical laboratories to collect co-payments from patients which may increase our costs and reduce the amount ultimately collected.

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***Complying with numerous statutes and regulations pertaining to our business is an expensive and time-consuming process, and any failure to comply could result in substantial penalties.***

We are subject to other regulation by both the federal government and the states in which we conduct our business, including:

Medicare billing and payment regulations applicable to clinical laboratories;

the Federal anti-kickback law and state anti-kickback prohibitions;

the Federal physician self-referral prohibition, commonly known as the Stark Law, and state equivalents;

the Federal Health Insurance Portability and Accountability Act of 1996;

the Medicare civil money penalty and exclusion requirements;

the Federal False Claims Act civil and criminal penalties and state equivalents; and

the Foreign Corrupt Practices Act of 1977, which applies to our international activities.

We have adopted policies and procedures designed to comply with these laws and regulations. In the ordinary course of our business, we conduct internal reviews of our compliance with these laws. Our compliance is also subject to governmental review. The growth of our business and sales organization and our expansion outside of the United States may increase the potential of violating these laws or our internal policies and procedures. 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 these laws and regulations, we may be subject to any applicable penalty associated with the violation, including civil and criminal penalties, damages and fines, we could be required to refund payments received by us, and we could be required to curtail or cease our operations. Any of the foregoing consequences could seriously harm our business and our financial results.

***If we are sued for product liability or errors and omissions liability, we could face substantial liabilities that exceed our resources.***

The marketing, sale and use of Afirma could lead to product liability claims if someone were to allege that the GEC failed to perform as it was designed. We may also be subject to liability for errors in the results we provide to physicians or for a misunderstanding of, or inappropriate reliance upon, the information we provide. Our GEC is performed on FNA samples that are diagnosed as indeterminate by standard cytopathology review. We report results as benign or suspicious to the prescribing physician. Under certain circumstances, we might report a result as benign that later proves to have been malignant. This could be the result of the physician having poor nodule sampling in collecting the FNA, performing the FNA on a different nodule than the one that is malignant or failure of the GEC to perform as intended. We may also be subject to similar types of claims related to products we may develop in the future. A product liability or errors and omissions liability claim could result in substantial damages and be costly and time consuming for us to defend. Although we maintain product liability and errors and omissions insurance, we cannot assure you that our insurance would fully protect us from the financial impact of defending against these types of claims or any judgments, fines or settlement costs arising out of any such claims. Any product liability or errors and omissions liability claim brought against us, with or without merit, could increase our insurance rates or prevent us from securing insurance coverage in the future. Additionally, any product liability lawsuit could cause injury to our reputation or cause us to

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suspend sales of our products and solutions. The occurrence of any of these events could have an adverse effect on our business and results of operations.

***The loss of members of our senior management team or our inability to attract and retain key personnel could adversely affect our business.***

Our success depends largely on the skills, experience and performance of key members of our executive management team and others in key management positions. The efforts of each of these persons together will be critical to us as we continue to develop our technologies and test processes and focus on our growth. If we were to lose one or more of these key employees, we may experience difficulties in competing effectively, developing our technologies and implementing our business strategy.

In addition, our research and development programs and commercial laboratory operations depend on our ability to attract and retain highly skilled scientists, including licensed clinical laboratory scientists and biostatisticians. We may not be able to attract or retain qualified scientists and technicians in the future due to the intense competition for qualified personnel among life science businesses, particularly in the San Francisco Bay Area. Because it is expected that there will be a shortage of clinical laboratory scientists in coming years, it may become more difficult to hire sufficient numbers of qualified personnel. We also face competition from universities and public and private research institutions in recruiting and retaining highly qualified scientific personnel. Additionally, our success depends on our ability to attract and retain qualified salespeople, and in 2014 we plan to significantly expand our sales force. We may have difficulties locating, recruiting or retaining qualified salespeople, which could cause a delay or decline in the rate of adoption of our solution. If we are not able to attract and retain the necessary personnel to accomplish our business objectives, we may experience constraints that could adversely affect our ability to support our research and development, clinical laboratory and sales efforts. All of our employees are at-will, which means that either we or the employee may terminate their employment at any time. We do not carry key man insurance for any of our employees.

***If our laboratory in South San Francisco becomes inoperable due to an earthquake or either of our laboratories becomes inoperable for any other reason, we will be unable to perform our testing services and our business will be harmed.***

We perform all of the GEC testing at our laboratory in South San Francisco, California. Our laboratory in Austin, Texas accepts and stores substantially all FNA samples pending transfer to our California laboratory for GEC processing. The equipment we use to perform the GEC would be costly to replace and could require substantial lead time to replace and qualify for use. Either of our facilities may be harmed or rendered inoperable by natural or man-made disasters, including earthquakes, flooding and power outages, which may render it difficult or impossible for us to perform our testing services for some period of time or to receive and store samples. The inability to perform GEC testing or the backlog of GEC tests that could develop if our California facility is inoperable for even a short period of time may result in the loss of customers or harm our reputation, and we may be unable to regain those customers in the future. Although we maintain insurance for damage to our property and the disruption of our business, this insurance may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, if at all.

***If we cannot enter into new clinical study collaborations, our product development and subsequent commercialization could be delayed.***

In the past, we have entered into clinical study collaborations, and our success in the future depends in part on our ability to enter into additional collaborations with highly regarded institutions. This can be difficult due to internal and external constraints placed on these organizations. Some organizations may limit the number of collaborations they have with any one company so as to not be perceived as biased or conflicted. Organizations may also have insufficient administrative and related infrastructure to enable

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collaborations with many companies at once, which can extend the time it takes to develop, negotiate and implement a collaboration. Additionally, organizations often insist on retaining the rights to publish the clinical data resulting from the collaboration. The publication of clinical data in peer-reviewed journals is a crucial step in commercializing and obtaining reimbursement for a diagnostic solution such as Afirma, and our inability to control when and if results are published may delay or limit our ability to derive sufficient revenue from any solution.

*If we use hazardous materials in a manner that causes contamination or injury, we could be liable for resulting damages.*

We are subject to federal, state and local laws, rules and regulations governing the use, discharge, storage, handling and disposal of biological material, chemicals and waste. We cannot eliminate the risk of accidental contamination or injury to employees or third parties from the use, storage, handling or disposal of these materials. In the event of contamination or injury, we could be held liable for any resulting damages, remediation costs and any related penalties or fines, and any liability could exceed our resources or any applicable insurance coverage we may have. The cost of compliance with these laws and regulations may become significant, and our failure to comply may result in substantial fines or other consequences, and either could negatively affect our operating results.

*Security breaches, loss of data and other disruptions to us or our third-party service providers could compromise sensitive information related to our business or prevent us from accessing critical information and expose us to liability, which could adversely affect our business and our reputation.*

In the ordinary course of our business, we and our third-party service providers collect and store sensitive data, including legally protected health information, personally identifiable information about our patients, credit card information, intellectual property, and our proprietary business and financial information. We manage and maintain our applications and data utilizing a combination of on-site systems, managed data center systems and cloud-based data center systems. We face a number of risks relative to our protection of, and our service providers' protection of, this critical information, including loss of access, inappropriate disclosure and inappropriate access, as well as risks associated with our ability to identify and audit such events.

The secure processing, storage, maintenance and transmission of this critical information is vital to our operations and business strategy, and we devote significant resources to protecting such information. Although we take measures to protect sensitive information from unauthorized access or disclosure, our information technology and infrastructure may be vulnerable to attacks by hackers or viruses or otherwise breached due to employee error, malfeasance or other activities. While we have not experienced any such attack or breach, if such event would occur and cause interruptions in our operations, our networks would be compromised and the information we store on those networks could be accessed by unauthorized parties, 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, such as the Health Insurance Portability and Accountability Act of 1996, and regulatory penalties. Unauthorized access, loss or dissemination could also disrupt our operations, including our ability to process tests, provide test results, bill payers or patients, process claims and appeals, provide customer assistance services, conduct research and development activities, collect, process and prepare company financial information, provide information about our solution and other patient and physician education and outreach efforts through our website, manage the administrative aspects of our business and damage our reputation, any of which could adversely affect our business.

In addition, the interpretation and application of consumer, health-related and data protection laws in the United States, Europe and elsewhere are often uncertain, contradictory and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our practices. If so, this could result in government-imposed fines or orders requiring that we change our practices, which could

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adversely affect our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices, systems and compliance procedures in a manner adverse to our business.

***If we cannot license rights to use technologies on reasonable terms, we may not be able to commercialize new products in the future.***

In the future, we may license third-party technology to develop or commercialize new products. In return for the use of a third-party's technology, we may agree to pay the licensor royalties based on sales of our solutions. Royalties are a component of cost of revenue and affect the margins on our solutions. We may also need to negotiate licenses to patents and patent applications after introducing a commercial product. Our business may suffer if we are unable to enter into the necessary licenses on acceptable terms, or at all, if any necessary licenses are subsequently terminated, if the licensors fail to abide by the terms of the license or fail to prevent infringement by third parties, or if the licensed patents or other rights are found to be invalid or unenforceable.

***If we are unable to protect our intellectual property effectively, our business would be harmed.***

We rely on patent protection as well as trademark, copyright, trade secret and other intellectual property rights protection and contractual restrictions to protect our proprietary technologies, all of which provide limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. If we fail to protect our intellectual property, third parties may be able to compete more effectively against us and we may incur substantial litigation costs in our attempts to recover or restrict use of our intellectual property.

We apply for patents covering our products and technologies and uses thereof, as we deem appropriate, however we may fail to apply for patents on important products and technologies in a timely fashion or at all, or we may fail to apply for patents in potentially relevant jurisdictions. We have seven pending United States nonprovisional patent applications and two patents which expire between 2030 and 2031 related to methods that are used in the Afirma diagnostic and one pending United States provisional patent application relating to our lung disease product under development. It is possible that none of our pending patent applications will result in issued patents in a timely fashion or at all, and even if patents are granted, they may not provide a basis for intellectual property protection of commercially viable products, may not provide us with any competitive advantages, or may be challenged and invalidated by third parties. It is possible that others will design around our current or future patented technologies. We may not be successful in defending any challenges made against our patents or patent applications. Any successful third-party challenge to our patents could result in the unenforceability or invalidity of such patents and increased competition to our business. The outcome of patent litigation can be uncertain and any attempt by us to enforce our patent rights against others may not be successful, or, if successful, may take substantial time and result in substantial cost, and may divert our efforts and attention from other aspects of our business.

The patent positions of life sciences companies can be highly uncertain and involve complex legal and factual questions for which important legal principles remain unresolved. No consistent policy regarding the breadth of claims allowed in such companies' patents has emerged to date in the United States or elsewhere. Courts frequently render opinions in the biotechnology field that may affect the patentability of certain inventions or discoveries, including opinions that may affect the patentability of methods for analyzing or comparing DNA.

In particular, the patent positions of companies engaged in the development and commercialization of genomic diagnostic tests, like Afirma, are particularly uncertain. Various courts, including the U.S. Supreme Court, have recently rendered decisions that affect the scope of patentability of certain inventions or discoveries relating to certain diagnostic tests and related methods. These decisions state, among other

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things, that patent claims that recite laws of nature (for example, the relationship between blood levels of certain metabolites and the likelihood that a dosage of a specific drug will be ineffective or cause harm) are not themselves patentable. What constitutes a law of nature is uncertain, and it is possible that certain aspects of genetic diagnostics tests would be considered natural laws. Accordingly, the evolving case law in the United States may adversely affect our ability to obtain patents and may facilitate third-party challenges to any owned and licensed patents. The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the United States, and we may encounter difficulties protecting and defending such rights in foreign jurisdictions. The legal systems of many other countries do not favor the enforcement of patents and other intellectual property protection, particularly those relating to biotechnology, which could make it difficult for us to stop the infringement of our patents in such countries. Proceedings to enforce our patent rights in foreign jurisdictions could result in substantial cost and divert our efforts and attention from other aspects of our business.

Changes in either the patent laws or in interpretations of patent laws in the United States or other countries may diminish the value of our intellectual property. We cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents. We may not develop additional proprietary products, methods and technologies that are patentable.

In addition to pursuing patents on our technology, we take steps to protect our intellectual property and proprietary technology by entering into agreements, including confidentiality agreements, non-disclosure agreements and intellectual property assignment agreements, with our employees, consultants, academic institutions, corporate partners and, when needed, our advisors. Such agreements may not be enforceable or may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements, and we may not be able to prevent such unauthorized disclosure. If we are required to assert our rights against such party, it could result in significant cost and distraction.

Monitoring unauthorized disclosure is difficult, and we do not know whether the steps we have taken to prevent such disclosure are, or will be, adequate. If we were to enforce a claim that a third-party had illegally obtained and was using our trade secrets, it would be expensive and time consuming, and the outcome would be unpredictable. In addition, courts outside the United States may be less willing to protect trade secrets.

We may also be subject to claims that our employees have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers, or to claims that we have improperly used or obtained such trade secrets. Litigation may be necessary to defend against these claims. If we fail in defending such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights and face increased competition to our business. A loss of key research personnel work product could hamper or prevent our ability to commercialize potential products, which could harm our business. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management.

Further, competitors could attempt to replicate some or all of the competitive advantages we derive from our development efforts, willfully infringe our intellectual property rights, design around our protected technology or develop their own competitive technologies that fall outside of our intellectual property rights. Others may independently develop similar or alternative products and technologies or replicate any of our products and technologies. If our intellectual property does not adequately protect us against competitors' products and methods, our competitive position could be adversely affected, as could our business.

We have not registered certain of our trademarks, including Afirma, in all of our potential markets. If we apply to register these trademarks, our applications may not be allowed for registration in a timely fashion or at all, and our registered trademarks may not be maintained or enforced. In addition, opposition or cancellation proceedings may be filed against our trademark applications and registrations, and our

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trademarks may not survive such proceedings. If we do not secure registrations for our trademarks, we may encounter more difficulty in enforcing them against third parties than we otherwise would.

To the extent our intellectual property offers inadequate protection, or is found to be invalid or unenforceable, we would be exposed to a greater risk of direct competition. If our intellectual property does not provide adequate coverage of our competitors' products, our competitive position could be adversely affected, as could our business. Both the patent application process and the process of managing patent disputes can be time consuming and expensive.

***We may be involved in litigation related to intellectual property, which could be time-intensive and costly and may adversely affect our business, operating results or financial condition.***

We may receive notices of claims of direct or indirect infringement or misappropriation or misuse of other parties' proprietary rights from time to time. Some of these claims may lead to litigation. We cannot assure you that we will prevail in such actions, or that other actions alleging misappropriation or misuse by us of third-party trade secrets, infringement by us of third-party patents and trademarks or other rights, or the validity of our patents, trademarks or other rights, will not be asserted or prosecuted against us.

We might not have been the first to make the inventions covered by each of our pending patent applications and we might not have been the first to file patent applications for these inventions. To determine the priority of these inventions, we may have to participate in interference proceedings, derivation proceedings, or other post-grant proceedings declared by the United States Patent and Trademark Office that could result in substantial cost to us. No assurance can be given that other patent applications will not have priority over our patent applications. In addition, recent changes to the patent laws of the United States allow for various post-grant opposition proceedings that have not been extensively tested, and their outcome is therefore uncertain. Furthermore, if third parties bring these proceedings against our patents, we could experience significant costs and management distraction.

Litigation may be necessary for us to enforce our patent and proprietary rights or to determine the scope, coverage and validity of the proprietary rights of others. The outcome of any litigation or other proceeding is inherently uncertain and might not be favorable to us, and we might not be able to obtain licenses to technology that we require on acceptable terms or at all. Further, we could encounter delays in product introductions, or interruptions in product sales, as we develop alternative methods or products. In addition, if we resort to legal proceedings to enforce our intellectual property rights or to determine the validity, scope and coverage of the intellectual property or other proprietary rights of others, the proceedings could be burdensome and expensive, even if we were to prevail. Any litigation that may be necessary in the future could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results or financial condition.

As we move into new markets and applications for our products, incumbent participants in such markets may assert their patents and other proprietary rights against us as a means of slowing our entry into such markets or as a means to extract substantial license and royalty payments from us. Our competitors and others may now and, in the future, have significantly larger and more mature patent portfolios than we currently have. In addition, future litigation may involve patent holding companies or other adverse patent owners who have no relevant product revenue and against whom our own patents may provide little or no deterrence or protection. Therefore, our commercial success may depend in part on our non-infringement of the patents or proprietary rights of third parties. Numerous significant intellectual property issues have been litigated, and will likely continue to be litigated, between existing and new participants in our existing and targeted markets and competitors may assert that our products infringe their intellectual property rights as part of a business strategy to impede our successful entry into or growth in those markets. Third parties may assert that we are employing their proprietary technology without authorization. In addition, our competitors and others may have patents or may in the future obtain patents and claim that making, having made, using, selling, offering to sell or importing our



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products infringes these patents. We could incur substantial costs and divert the attention of our management and technical personnel in defending against any of these claims. Parties making claims against us may be able to obtain injunctive or other relief, which could block our ability to develop, commercialize and sell products, and could result in the award of substantial damages against us. In the event of a successful claim of infringement against us, we may be required to pay damages and ongoing royalties, and obtain one or more licenses from third parties, or be prohibited from selling certain products. We may not be able to obtain these licenses on acceptable terms, if at all. We could incur substantial costs related to royalty payments for licenses obtained from third parties, which could negatively affect our financial results. In addition, we could encounter delays in product introductions while we attempt to develop alternative methods or products to avoid infringing third-party patents or proprietary rights. Defense of any lawsuit or failure to obtain any of these licenses could prevent us from commercializing products, and the prohibition of sale of any of our products could materially affect our business and our ability to gain market acceptance for our products.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments. If securities analysts or investors perceive these results to be negative, it could have a substantial adverse effect on the price of our common stock.

In addition, our agreements with some of our customers, suppliers or other entities with whom we do business require us to defend or indemnify these parties to the extent they become involved in infringement claims, including the types of claims described above. We could also voluntarily agree to defend or indemnify third parties in instances where we are not obligated to do so if we determine it would be important to our business relationships. If we are required or agree to defend or indemnify third parties in connection with any infringement claims, we could incur significant costs and expenses that could adversely affect our business, operating results, or financial condition.

***Our inability to raise additional capital on acceptable terms in the future may limit our ability to develop and commercialize new solutions and technologies and expand our operations.***

We expect capital expenditures and operating expenses to increase over the next several years as we expand our infrastructure, commercial operations and research and development activities. We may seek to raise additional capital through equity offerings, debt financings, collaborations or licensing arrangements. Additional funding may not be available to us on acceptable terms, or at all. If we raise funds by issuing equity securities, dilution to our stockholders could result. Any equity securities issued also may provide for rights, preferences or privileges senior to those of holders of our common stock. The terms of debt securities issued or borrowings could impose significant restrictions on our operations. The incurrence of additional indebtedness or the issuance of certain equity securities could result in increased fixed payment obligations and could also result in restrictive covenants, such as limitations on our ability to incur additional debt or issue additional equity, limitations on our ability to acquire or license intellectual property rights, and other operating restrictions that could adversely affect our ability to conduct our business. In addition, the issuance of additional equity securities by us, or the possibility of such issuance, may cause the market price of our common stock to decline. In the event that we enter into collaborations or licensing arrangements to raise capital, we may be required to accept unfavorable terms. These agreements may require that we relinquish or license to a third-party on unfavorable terms our rights to technologies or product candidates that we otherwise would seek to develop or commercialize ourselves, or reserve certain opportunities for future potential arrangements when we might be able to achieve more favorable terms. If we are not able to secure additional funding when needed, we may have to delay, reduce the scope of or eliminate one or more research and development programs or selling and

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marketing initiatives. In addition, we may have to work with a partner on one or more of our products or market development programs, which could lower the economic value of those programs to our company.

*We may experience limits on our revenue if patients decide not to use our test.*

Some patients may decide not to use Afirma due to its price, all or part of which may be payable directly by the patient if the patient's insurer denies reimbursement in full or in part. There is a growing trend among insurers to shift more of the cost of healthcare to patients in the form of higher co-payments or premiums. In addition, the current economic environment in the United States has and may continue to result in the loss of healthcare coverage. Implementation of provisions of the PPACA has also resulted in the loss of health insurance, and increases in premiums and reductions in coverage, for some patients. These events may result in patients delaying or forgoing medical checkups or treatment due to their inability to pay for our test, which could have an adverse effect on our revenue.

**Risks Related to Being a Public Company**

*We will continue to incur increased costs and demands on management as a result of compliance with laws and regulations applicable to public companies, which could harm our operating results.*

As a public company, we will continue to incur significant legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting requirements. In addition, the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, as well as rules implemented by the Securities and Exchange Commission, or the SEC, and The NASDAQ Stock Market, impose a number of requirements on public companies, including with respect to corporate governance practices. Our management and other personnel will need to devote a substantial amount of time to these compliance and disclosure obligations. Moreover, these rules and regulations have and will continue to increase our legal, accounting and financial compliance costs and make some activities more time-consuming and costly. We also expect that it will continue to be expensive for us to maintain director and officer liability insurance.

*If we are unable to implement and maintain effective internal control over financial reporting, investors may lose confidence in the accuracy and completeness of our reported financial information and the market price of our common stock may be negatively affected.*

As a public company, we will be required to maintain internal control over financial reporting and to report any material weaknesses in such internal control. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we evaluate and determine the effectiveness of our internal control over financial reporting and, beginning with our annual report for the year ending December 31, 2014, provide a management report on the internal control over financial reporting. If we have a material weakness in our internal control over financial reporting, we may not detect errors on a timely basis and our financial statements may be materially misstated. We are in the process of compiling the system and processing documentation necessary to perform the evaluation needed to comply with Section 404 of the Sarbanes-Oxley Act. We may not be able to complete our evaluation, testing and any required remediation in a timely fashion. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting, our management will be unable to conclude that our internal control over financial reporting is effective. Moreover, when we are no longer an emerging growth company, our independent registered public accounting firm will be required to issue an attestation report on the effectiveness of our internal control over financial reporting. Even if our management concludes that our internal control over financial reporting is effective, our independent registered public accounting firm may conclude that there are material weaknesses with respect to our internal controls or the level at which our internal controls are documented, designed, implemented or reviewed.

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If we are unable to conclude that our internal control over financial reporting is effective, or when we are no longer an emerging growth company, if our auditors were to express an adverse opinion on the effectiveness of our internal control over financial reporting because we had one or more material weaknesses, investors could lose confidence in the accuracy and completeness of our financial disclosures, which could cause the price of our common stock to decline. Internal control deficiencies could also result in a restatement of our financial results in the future.

*We are an emerging growth company and may elect to comply with reduced public company reporting requirements applicable to emerging growth companies, which could make our common stock less attractive to investors.*

We are an emerging growth company, as defined under the Securities Act of 1933, or the Securities Act. We will remain an emerging growth company for up to five years, although if our revenue exceeds \$1 billion in any fiscal year before that time, we would cease to be an emerging growth company as of the end of that fiscal year. In addition, if the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our second fiscal quarter of any fiscal year before the end of that five-year period, we would cease to be an emerging growth company as of December 31 of that year. As an emerging growth company, we may choose to take advantage of exemptions from various reporting requirements applicable to certain other public companies, including not being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002, reduced financial statement and financial-related disclosures, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, and exemptions from the requirement of holding a nonbinding advisory vote on executive compensation and obtaining stockholder approval of any golden parachute payments not previously approved by our stockholders. We cannot predict whether investors will find our common stock less attractive if we choose to rely on any of these exemptions. If some investors find our common stock less attractive as a result of any choices to reduce future disclosure we may make, there may be a less active trading market for our common stock and our stock price may be more volatile.

**Risks Related to Our Common Stock**

*Our stock price may be volatile, and you may not be able to sell shares of our common stock at or above the price you paid.*

Prior to our initial public offering in October 2013, there has been no public market for our common stock, and an active and liquid public market for our stock may not develop or be sustained. In addition, the trading price of our common stock is likely to be highly volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control. These factors include:

actual or anticipated variations in our and our competitors' results of operations;

announcements by us or our competitors of new products, commercial relationships or capital commitments;

changes in reimbursement by current or potential payers;

issuance of new securities analysts' reports or changed recommendations for our stock;

periodic fluctuations in our revenue, due in part to the way in which we recognize revenue;

actual or anticipated changes in regulatory oversight of our products;

developments or disputes concerning our intellectual property or other proprietary rights;

commencement of, or our involvement in, litigation;

announced or completed acquisitions of businesses or technologies by us or our competitors;



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any major change in our management; and

general economic conditions and slow or negative growth of our markets.

In addition, the stock market in general, and the market for stock of life sciences companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of our common stock, regardless of our actual operating performance. These fluctuations may be even more pronounced in the trading market for our stock shortly following our initial public offering. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

***If securities or industry analysts issue an adverse opinion regarding our stock or do not publish research or reports about our company, our stock price and trading volume could decline.***

The trading market for our common stock will depend in part on the research and reports that equity research analysts publish about us and our business. We do not control these analysts or the content and opinions included in their reports. Securities analysts may elect not to provide research coverage of our company, and such lack of research coverage may adversely affect the market price of our common stock. The price of our common stock could also decline if one or more equity research analysts downgrade our common stock or if those analysts issue other unfavorable commentary or cease publishing reports about us or our business. If one or more equity research analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

***Future sales of shares by existing stockholders could cause our stock price to decline.***

If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market after the lock-up and other legal restrictions on resale resulting from our recent initial public offering, the trading price of our common stock could decline. On March 1, 2014, 21,143,313 shares of common stock were outstanding. Of these shares, 5,100,351 are freely tradable, without restriction, in the public market. Each of our directors and officers and substantially all of our other stockholders has entered into a lock-up agreement with the underwriters of our initial public offering that restricts their ability to sell or transfer their shares. The lock-up agreements will expire in April 2014. The underwriters, however, may, in their sole discretion, waive the contractual lock-up prior to the expiration of the lock-up agreements. After the lock-up agreements expire, based on shares outstanding as of March 1, 2014, up to an additional 16,042,962 shares of common stock will be eligible for sale in the public market, of which 14,825,544 shares are held by directors, executive officers and other affiliates and will be subject to volume limitations under Rule 144 under the Securities Act, and various vesting agreements. In addition, 3,027,419 shares of common stock that are subject to outstanding options as of March 1, 2014 will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act. We have filed a registration statement on Form S-8 under the Securities Act covering all of the shares of common stock subject to options outstanding and reserved for issuance under our stock plans. This registration statement became effective immediately upon filing, and shares covered by this registration statement are eligible for sale in the public markets, subject to Rule 144 limitations applicable to affiliates and any lock-up agreements described above. If these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

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***Insiders have substantial control over us and will be able to influence corporate matters.***

As of March 1, 2014, directors and executive officers and their affiliates beneficially owned, in the aggregate, 71.5% of our outstanding capital stock. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership could limit stockholders' ability to influence corporate matters and may have the effect of delaying or preventing a third-party from acquiring control over us.

***Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay or prevent a change in control and may affect the trading price of our common stock.***

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

authorize our board of directors to issue, without further action by the stockholders, up to shares of undesignated preferred 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, our chairman of the board, or our chief executive officer;

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;

provide that vacancies on our board of directors may, except as otherwise required by law, be filled only by a majority of directors then in office, even if less than a quorum;

specify that no stockholder is permitted to cumulate votes at any election of directors; and

require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions.

***We have never paid dividends on our capital stock, and we do not anticipate paying dividends in the foreseeable future.***

We have never paid dividends on any of our capital stock and currently intend to retain any future earnings to fund the growth of our business. In addition, our loan and security agreement restricts our ability to pay cash dividends on our common stock and we may also enter into credit agreements or other borrowing arrangements in the future that will restrict our ability to declare or pay cash dividends on our common stock. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend on our

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financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant. As a result, capital appreciation, if any, of our common stock will be the sole source of gain for the foreseeable future.

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None.

**ITEM 2. PROPERTIES**

We lease 24,000 square feet of office and laboratory space at our headquarters in South San Francisco, California, under a lease that expires in 2016, with an option for us to extend the lease for an additional three years. We also lease approximately 10,400 square feet of office and laboratory space in Austin, Texas, under a lease that expires in 2018, with an option for us to extend the lease for an additional five years. We believe that our existing facilities are adequate to meet our business requirements for at least the next 12 months. However, given that laboratory space is specialized and in limited supply in the San Francisco Bay Area, we regularly review our facilities needs and local available space. We believe that additional space will be available on commercially reasonable terms, if required.

**ITEM 3. LEGAL PROCEEDINGS**

We are not currently a party to any material legal proceedings. We may from time to time become involved in legal proceedings arising in the ordinary course of business.

**ITEM 4. MINE SAFETY DISCLOSURE**

Not applicable.

**EXECUTIVE OFFICERS OF THE REGISTRANT**

Our executive officers and their ages and positions as of March 1, 2014, are as set forth below:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Bonnie H. Anderson	55	President, Chief Executive Officer and Director
Shelly D. Guyer	53	Chief Financial Officer and Secretary
Christopher M. Hall	45	Chief Commercial Officer

*Bonnie H. Anderson* has served as our Chief Executive Officer and as a member of our board of directors since February 2008. In August 2013, she was appointed as our President. Prior to joining us, Ms. Anderson was an independent strategic consultant from April 2006 to January 2008, including as a strategic consultant for us from July 2007 to January 2008. Ms. Anderson was a Vice President at Beckman Coulter, Inc., a manufacturer of biomedical testing instrument systems, tests and supplies, from September 2000 to March 2006. She currently serves as a member of the Board of Trustees of the Keck Graduate Institute of Applied Life Sciences. Ms. Anderson holds a B.S. in Medical Technology from Indiana University of Pennsylvania. Our board of directors has concluded that Ms. Anderson should serve on our board of directors due to her extensive industry experience, strategic perspective of our development, historic knowledge of our company and key leadership position as our President and Chief Executive Officer.

*Shelly D. Guyer* has served as our Chief Financial Officer and Secretary since April 2013. Prior to joining us, Ms. Guyer served as Chief Financial Officer and Executive Vice President of Finance and Administration of iRhythm Technologies, Inc., a medical device and service company, from April 2008 to December 2012. From March 2006 to August 2007, Ms. Guyer served as Vice President of Business Development and Investor Relations of Nuvelo Inc., a biopharmaceutical company. Prior to joining Nuvelo, Ms. Guyer worked at J.P. Morgan Securities and its predecessor companies for over 17 years, serving in a variety of roles including in healthcare investment banking. Ms. Guyer holds a A.B. in Politics from Princeton University and an M.B.A. from the Haas School of Business at the University of California, Berkeley.



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*Christopher M. Hall* has served as our Chief Commercial Officer since March 2010. Prior to joining us, Mr. Hall served as Chief Business Officer of Celera Corporation, a diagnostics company focusing on personalized disease management, from October 2008 to February 2010. From August 2002 to February 2010, Mr. Hall served in various executive and senior positions at Berkeley HeartLab, Inc., a cardiovascular disease management company that was acquired by Celera in October 2007, including Chief Clinical Operations Officer and Vice President of Marketing. Mr. Hall holds a B.A. in Economics and Political Science from DePauw University and an M.B.A. from Harvard University.

**PART II**

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

**Market Information**

Our common stock is traded on The NASDAQ Global Market under the symbol "VCYT." As of March 1, 2014, there were approximately 59 holders of record of our common stock. The high and low sales prices for our common stock on The NASDAQ Global Market for the period from October 30, 2013 (the date our common stock began trading following our initial public offering) to December 31, 2013 were \$14.80 and \$10.88, respectively.

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The following information is not deemed to be "soliciting material" or to be "filed" with the Securities and Exchange Commission or subject to Regulation 14A or 14C under the Securities Exchange Act of 1934 or to the liabilities of Section 18 of the Securities Exchange Act of 1934, and will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate it by reference into such a filing.

The graph below shows the cumulative total stockholder return (change in stock price plus reinvested dividends) assuming the investment of \$100 on the date specified in each of our Common Stock, the NASDAQ Market Index, and the NASDAQ Biotechnology Index for the period commencing on October 30, 2013 (the date our common stock began trading following our initial public offering) and ending on December 31, 2013. The comparison is required by the Securities and Exchange Commission and is not intended to forecast or be indicative of future performance of our common stock.

Trade Date	Veracyte, Inc.	Total Return	
		NASDAQ Market Index	NASDAQ Biotech
10/30/2013	\$100.00	\$100.00	\$100.00
11/29/2013	\$ 98.00	\$104.00	\$109.00
12/31/2013	\$109.00	\$107.00	\$111.00

**Dividend Policy**

We have never declared or paid any cash dividend on our capital stock. We currently intend to retain any future earnings and do not expect to pay any dividends in the foreseeable future. Our loan and security agreement restricts our ability to pay cash dividends on our common stock, and we may also enter into



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credit agreements or other borrowing arrangements in the future that will further restrict our ability to declare or pay cash dividends on our common stock. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend on our financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

**Use of Proceeds**

On November 4, 2013, we completed an initial public offering ("IPO") of our common stock. In connection with our IPO, we issued and sold 5,100,351 shares of common stock at a price to the public of \$13.00 per share. As a result of the IPO, we received approximately \$59.2 million in net proceeds, after deducting underwriting discounts and commissions of \$4.6 million and offering expenses of \$2.5 million payable by us. The offering was completed in November 2013 at which time an additional 649,649 registered shares were unsold.

We registered the shares under the Securities Act on a Registration Statement on Form S-1 (Registration No. 333-191282), which was filed on September 20, 2013 and declared effective on October 29, 2013, and on a Registration Statement on Form S-1 (Registration No. 333-1919782), which was filed on October 30, 2013 and was immediately effective.

From the date of the initial closing of the IPO through March 1, 2014, we have used a portion of the net proceeds from the sale of these securities to fund our operations, to make capital expenditures, for working capital and for other general corporate purposes.

**Sales of Unregistered Securities**

From January 1, 2013 through November 4, 2013, we granted stock options under our 2008 Stock Plan to purchase 695,029 shares of our common stock at exercise prices ranging from \$4.00 to \$12.12 per share, and issued an aggregate of 185,445 shares of common stock pursuant to the exercise of stock options with aggregate proceeds of approximately \$0.6 million. These issuances were undertaken in reliance upon an exemption from registration under Rule 701 of the Securities Act of 1933.

In June 2013, we issued 6,904,761 shares of our Series C convertible preferred stock with aggregate proceeds of \$13.0 million. Also in June 2013, we issued a warrant to purchase 99,206 shares of our Series C preferred stock, which became exercisable for 24,801 shares of our common stock upon completion of our IPO. These issuances were undertaken in reliance upon an exemption from registration under Section 4(2) of the Securities Act of 1933 or Regulation D promulgated thereunder.

None of the above transactions involved any underwriters, underwriting discounts or commissions.

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

The information set forth below should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and related notes included elsewhere in this annual report. The selected consolidated balance sheet data at December 31, 2013 and 2012 and the selected consolidated statements of operations data for each of the years ended December 31, 2013, 2012 and 2011 have been derived from our audited consolidated financial statements that are included elsewhere in this report. The financial data included in this report are historical and are not necessarily indicative of results to be expected in any future period.

	Year Ended December 31,		
	2013	2012	2011
(In thousands except share and per share data)			
<b>Statements of Operations Data:</b>			
Revenue	\$ 21,884	\$ 11,628	\$ 2,645
Operating expenses:			
Cost of revenue(1)	12,607	7,584	2,925
Research and development(1)	7,810	6,608	6,680
Selling and marketing(1)	12,540	8,447	2,934
General and administrative(1)	12,100	7,918	5,372
Total operating expenses(1)	45,057	30,557	17,911
Loss from operations	(23,173)	(18,929)	(15,266)
Interest income	5	2	2
Interest expense	(233)		
Other income (expense), net	(2,179)	278	819
Net loss	\$ (25,580)	\$ (18,649)	\$ (14,445)
Net loss per common share, basic and diluted	\$ (6.15)	\$ (28.68)	\$ (24.90)
Shares used in computing net loss per common share, basic and diluted	4,158,664	650,333	580,061
<b>Other Operating Data:</b>			
FNAs received	49,670	25,890	6,402

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Includes employee stock-based compensation as follows:

	Year Ended December 31,		
	2013	2012	2011
	(In thousands)		
Cost of revenue	\$ 34	\$ 26	\$ 32
Research and development	250	131	130
Selling and marketing	169	111	77
General and administrative	794	407	227
<b>Total stock-based compensation</b>	<b>\$ 1,247</b>	<b>\$ 675</b>	<b>\$ 466</b>

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	As of December 31,		
	2013	2012	2011
	(In thousands)		
Cash and cash equivalents	\$ 71,220	\$ 14,002	\$ 7,566
Working capital	61,019	7,390	6,707
Total assets	79,630	19,067	10,451
Convertible preferred stock		63,372	49,296
Accumulated deficit	(85,649)	(60,069)	(41,420)
Total stockholders' equity (deficit)	56,443	(58,471)	(40,766)

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

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this report. This discussion contains certain forward-looking statements that involve risk and uncertainties. Our actual results may differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below and those set forth under the Section entitled "Risk Factors" in Item 1A, and other documents we file with the Securities and Exchange Commission. Historical results are not necessarily indicative of future results.*

**Overview**

We are a diagnostics company pioneering the field of molecular cytology to improve patient outcomes and lower healthcare costs. We specifically target diseases that often require invasive procedures for an accurate diagnosis—diseases where many healthy patients undergo costly interventions that ultimately prove unnecessary. We improve the accuracy of diagnosis at an earlier stage of patient care by deriving clinically actionable genomic information from cytology samples collected in an outpatient setting. We developed our first commercial solution, the Afirma Thyroid FNA Analysis, or Afirma, to address a significant unmet need in thyroid nodule diagnosis. In the United States alone, physicians perform over 525,000 fine needle aspiration, or FNA, biopsies annually on thyroid nodules suspicious for cancer, which in approximately 15% to 30% of patients, FNAs analyzed using cytopathology testing alone yield inconclusive, or indeterminate, results. Prior to Afirma, the standard of care for patients with indeterminate cytopathology results was to surgically remove a portion or all of the thyroid. The Afirma solution includes as its centerpiece our Gene Expression Classifier, which we refer to as the GEC. The GEC helps physicians reduce the number of unnecessary surgeries by approximately 50% by employing a proprietary 142-gene signature to preoperatively determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign. We have demonstrated the clinical utility and cost effectiveness of the GEC in studies published in peer-reviewed journals and established the clinical validity of the GEC in a study published in *The New England Journal of Medicine* in 2012. Since we commercially launched Afirma in January 2011, we have received over 80,000 FNA samples for evaluation using Afirma and performed approximately 16,000 GECs to resolve indeterminate cytopathology results. We estimate the global, addressable market opportunity for Afirma to be approximately \$800 million, with the U.S. market comprising \$500 million of the total.

We market and sell Afirma with a sales force consisting of our own sales professionals and members of the Genzyme endocrinology sales team. In January 2012, we entered into a co-promotion agreement with Genzyme for the co-exclusive right to promote and market Afirma in the United States and in 40 countries pursuant to which we received a \$10.0 million fee from Genzyme. Under the agreement, we are required to pay Genzyme a co-promotion fee that is equal to a percentage of our cash receipts from Afirma.

We increased the list price for the GEC from \$4,275 to \$4,875 per test in January 2014, while the list price for routine cytopathology remained at \$490 per test. We obtained Medicare coverage for the GEC effective in January 2012 which provides reimbursement at an agreed upon rate. In addition, we received positive coverage decisions for the GEC from UnitedHealthcare in March 2013, Aetna in June 2013, Humana in July 2013, and Cigna in December 2013, and have also received positive coverage decisions from a number of other regional payers. Collectively, these payers represent more than 120 million covered lives. Reimbursement rates vary by payer.

Our revenue increased \$10.4 million, or 89%, from \$11.6 million for the year ended December 31, 2012 to \$21.9 million for the year ended December 31, 2013, and \$9.0 million, or 340%, from \$2.6 million for the year ended December 31, 2011 to \$11.6 million for the year ended December 31, 2012. We incurred



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a net loss of \$25.6 million, \$18.7 million and \$14.4 million for the years ended December 31, 2013, 2012 and 2011, respectively. As of December 31, 2013, we had an accumulated deficit of \$85.6 million.

**Factors Affecting Our Performance**

*The Number of FNAs We Receive and Test*

The growth in our business is tied to the number of FNAs we receive. Approximately 95% of FNAs we receive are for the Afirma solution, which consists of cytopathology, and if the cytopathology finding is indeterminate, the GEC. The remaining approximate 5% of FNAs are received from centers performing cytopathology in their institution where the cytopathology result is indeterminate and we perform the GEC only. Generally 5%-10% of the FNA samples we receive for cytopathology have insufficient cellular material from which to render a cytopathology diagnosis. We only bill the technical component, including slide preparation, for these tests. For results that are benign or suspicious/malignant, we bill for the cytopathology test. If the sample is indeterminate, defined as atypia/follicular lesions of undetermined significance (AUS/FLUS) or suspicious for FN/HCN, we perform the GEC. Historically, approximately 14%-17% of samples we have received for the Afirma solution have yielded indeterminate results by cytopathology. Of the FNA samples sent for GEC testing, approximately 5%-10% have insufficient RNA from which to render a finding. We issue a patient report classifying the sample as GEC Benign, GEC Suspicious or GEC No Result. We bill for the GEC Benign and GEC Suspicious results only. After the GEC is completed, we issue the cytopathology report for the indeterminate samples, and bill for the cytopathology portion of the test at this time. We incur costs of collecting and shipping the FNAs and a portion of the costs of performing tests where we cannot ultimately issue a patient report. Because we cannot bill for all samples received, the number of FNAs received does not directly correlate to the total number of patient reports issued and the amount billed.

*Continued Adoption of and Reimbursement for Afirma*

We increased our list price for the GEC from \$4,275 to \$4,875 per test in January 2014, while our list price for routine cytopathology remained at \$490 per test. To date only a portion of payers have reimbursed us at full list price. Revenue growth depends on our ability to achieve broader reimbursement at increased levels from third-party payers and to expand our base of prescribing physicians. To drive increased adoption of Afirma, we plan to increase our marketing efforts and to selectively increase our internal sales force in high-volume geographies domestically and to leverage our relationship with Genzyme to accelerate Afirma growth both in the United States and internationally. Because many payers consider the GEC experimental and investigational, we may not receive payment on many tests and payments may not be at acceptable levels compared to what we have billed. We expect our revenue growth will increase as more payers make a positive coverage decision, which should enhance our collections. If we are unable to expand the base of prescribing physicians at an acceptable rate, or if we are not able to execute our strategy for increasing reimbursement, we may not be able to effectively increase our revenue.

*How We Recognize Revenue*

A significant portion of our revenue is recognized when cash is received. Medicare and three small commercial payers are the only payers with agreed upon reimbursement rates or expected payments and a predictable history of collections, which allows us to recognize the related revenue on an accrual basis. Until we achieve a predictable pattern of collections and a consistent payment amount from a larger number of payers, we will recognize a large portion of our revenue upon the earlier of notification of payment or when cash is received. Additionally, as we commercialize new products, we will need to achieve a predictable pattern of collections and a consistent payment amount for each payer for each new product offering prior to being able to recognize the related revenue on an accrual basis. Because the timing and amount of cash payments received from payers is difficult to predict, we expect that our revenue will fluctuate significantly in any given quarter. In addition, even if we begin to accrue larger amounts of

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revenue related to Afirma, when we introduce new products we do not expect we will be able to recognize revenue from new products on an accrual basis for some period of time. This may result in continued fluctuations in our revenue.

As of December 31, 2012, amounts billed for tests processed which were not recognized as revenue upon delivery of a patient report because our accrual revenue recognition criteria were not met and for which we have not recognized either notification of payment or collected cash, totaled \$17.0 million. Of this amount, we recognized revenue of \$2.6 million in the year ended December 31, 2013.

As of December 31, 2013, amounts billed for tests processed which were not recognized as revenue upon delivery of a patient report because our accrual revenue recognition criteria were not met and for which we have not received either notification of payment or collected cash totaled \$40.9 million.

These amounts are cumulative as of the date referenced and include all amounts billed in prior periods that have not yet been paid or written off as uncollectible. It is difficult to predict future revenue from tests performed but where we have not been paid. Accordingly, we cannot provide any assurance as to when, if ever, or to what extent any of these amounts will be collected. Because we are in the early stages of commercialization of Afirma, we have had limited payment and collection history. Notwithstanding our efforts to obtain payment for these tests, payers may deny our claims, in whole or in part, and we may never receive revenue from any previously performed but unpaid tests. Revenue from these tests, if any, may not be equal to the billed amount due to a number of factors, including differences in reimbursement rates, the amounts of patient co-payments, the existence of secondary payers and claims denials.

We incur expense for tests in the period in which the test is conducted and recognize revenue for tests in the period in which our revenue recognition criteria are met. Accordingly, any revenue that we recognize as a result of cash collection in respect of previously performed but unpaid Afirma tests will favorably impact our liquidity and results of operations in future periods.

***Impact of Genzyme Co-promotion Agreement***

The \$10.0 million fee we received from Genzyme under our co-promotion agreement is being amortized over a four-year period beginning in 2012, and is recorded as a reduction of selling and marketing expenses. Under the agreement, we pay a portion of our cash receipts to Genzyme for co-promoting Afirma, and such amounts are recorded in selling and marketing expense. We incurred \$8.6 million and \$5.5 million in co-promotion fees in the years ended December 31, 2013 and 2012, respectively. The co-promotion agreement requires that we pay a certain percentage of our cash receipts to Genzyme, which percentage decreases over time. In January 2013, the percentage is 40%, but it will decrease to 32% on March 1, 2014 and remain at that level thereafter. As our cash collections grow, both from volume growth as well as from increased reimbursement rates and collections for Afirma, the total amount we pay to Genzyme will increase in absolute dollars although the percentage of revenue we are required to pay Genzyme decreases over time. We believe our relationship with Genzyme will accelerate sales of Afirma. As a result, our selling and marketing expense may be higher than what we would have incurred if we alone were marketing and promoting Afirma.

We also may receive up to an additional \$3.0 million from Genzyme, consisting of \$0.6 million for each of up to five countries outside of the United States in which we obtain regulatory authorization to market Afirma and achieve a specified level of reimbursement. Genzyme has also agreed to spend \$0.5 million to support clinical development expenses required for entry into the international markets covered by our agreement. This obligation expires in July 2014.

Our agreement with Genzyme expires in 2027 and either party may terminate the agreement at any time without cause and with six months' prior notice. If we terminate the agreement without cause between January 2014 and January 2015, we will be required to repay 40% of the \$10.0 million fee we received. The percentage decreases to 30% of such fee if we were to terminate the agreement between January 2015 and

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January 2016. Subsequent to January 2016, we are not required to repay any portion of the fee in the event we terminate the agreement without cause.

***Development of Additional Products***

We rely on sales of Afirma to generate all of our revenue. Our product development pipeline includes Afirma Malignancy Classifiers, which we believe will serve our current base of prescribing physicians. We also plan to pursue development of products for additional diseases to increase and diversify our revenue. For example, we are pursuing a solution for interstitial lung disease, or ILD, that will offer an alternative to surgery by developing a genomic signature to classify samples collected through less invasive bronchoscopy techniques. Accordingly, we expect to continue to invest heavily in research and development in order to expand the capabilities of our solution and to develop additional products. Our success in developing new products will be important in our efforts to grow our business by expanding the potential market for our products and diversifying our sources of revenue.

***Timing of Our Research and Development Expenses***

We deploy state-of-the-art and costly genomic technologies in our biomarker discovery experiments, and our spending on these technologies may vary substantially from quarter to quarter. We also spend a significant amount to secure clinical samples that can be used in discovery and product development as well as clinical validation studies. The timing of these research and development activities is difficult to predict, as is the timing of sample acquisitions. If a substantial number of clinical samples are acquired in a given quarter or if a high-cost experiment is conducted in one quarter versus the next, the timing of these expenses can affect our financial results. We conduct clinical studies to validate our new products as well as on-going clinical studies to further the published evidence to support our commercialized test, Afirma. As these studies are initiated, start-up costs for each site can be significant and concentrated in a specific quarter. Spending on research and development, for both experiments and studies, may vary significantly by quarter depending on the timing of these various expenses.

***Historical Seasonal Fluctuations in FNA Volume and Collections***

Our business is subject to fluctuations in FNA volume throughout the year as a result of physician practices being closed for holidays or endocrinology and thyroid-related industry meetings which are widely attended by our prescribing physicians. Like other companies in our field, vacations by physicians and patients tend to negatively affect our volumes more during the summer months and during the end of year holidays compared to other times of the year. Additionally, we may receive fewer FNAs in the winter months due to severe weather if patients are not able to visit their doctor's office. Our reimbursed rates and cash collections are also subject to seasonality. Medicare normally makes downward adjustments in its fee schedules at the beginning of the year which may negatively affect our reimbursement. Additionally, patient deductibles generally reset at the beginning of each year which means that patients early in the year are responsible for a greater portion of the cost of our tests, and we have lower collection rates from individuals than from third-party payers. Later in the year, particularly in the fourth quarter, we experience better payment results as third-party payers tend to clear pending claims toward year end. This trend historically has increased our cash collections in the fourth quarter and decreased cash collections for the subsequent first quarter of the succeeding year. The effects of these seasonal fluctuations in prior periods may have been obscured by the growth of our business.

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**Financial Overview**

***Revenue***

We generate revenue from the sale of our Afirma solution. We generally invoice third-party payers upon delivery of a patient report to the prescribing physician. As such, we take the assignment of benefits and the risk of collection from the third-party payer and individual patients.

For tests performed where an agreed upon reimbursement rate and/or a predictable history of collections exists, such as in the case of Medicare, we recognize revenue upon delivery of a patient report to the prescribing physician based on the established billing rate less contractual and other adjustments to arrive at the amount that we expect to collect. We determine the amount we expect to collect based on a per payer, per contract or agreement basis, after analyzing payment history. The expected amount is typically lower than the agreed upon reimbursement amount due to several factors, such as the amount of patient co-payments, the existence of secondary payers and claim denials. In all other situations, as we do not have sufficient history of collection and are not able to determine a predictable pattern of payment, we recognize revenue upon the earlier of receipt of third-party payer notification of payment or when cash is received. Upon ultimate collection, the amount received from Medicare and commercial payers with a predictable pattern of payment is compared to previous estimates and the contractual allowance is adjusted accordingly. Our ability to increase our revenue will depend on our ability to penetrate the market, obtain contracted reimbursement from additional third-party payers and increase our collection rate for tests performed.

***Cost of Revenue***

The components of our cost of revenue are materials and service costs, including cytopathology testing services, stock-based compensation expense, direct labor costs, equipment and infrastructure expenses associated with testing samples, shipping charges to transport samples, and allocated overhead including rent, information technology, equipment depreciation and utilities. Costs associated with performing tests are recorded as the test is processed regardless of whether and when revenue is recognized with respect to that test. As a result, our cost of revenue as a percentage of revenue may vary significantly from period to period because we do not recognize all revenue in the period in which the associated costs are incurred. We expect cost of revenue in absolute dollars to increase as the number of tests we perform increases. However, we expect that the cost per test will decrease over time due to the efficiencies we may gain as test volume increases and from automation, process efficiencies and other cost reductions.

***Research and Development***

Research and development expenses include costs incurred to develop our technology, collect clinical samples and conduct clinical studies to develop and support our products. These costs consist of personnel costs, including stock-based compensation expense, prototype materials, laboratory supplies, consulting costs, costs associated with setting up and conducting clinical studies at domestic and international sites, and allocated overhead including rent, information technology, equipment depreciation and utilities. We expense all research and development costs in the periods in which they are incurred. We expect our research and development expenses will increase in absolute dollars in future periods as we continue to invest in research and development activities related to developing additional products and evaluating various platforms. We expect that in the next 12 months the increase in research and development expenses will be for the continued development and support of Afirma and other new products and programs under development, including Afirma Malignancy Classifiers and our lung program. Specifically, we plan to increase the body of clinical and pharmacoeconomic evidence to support inclusion in additional clinical practice guidelines in order to expand our base of prescribing physicians and achieve broader

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reimbursement for Afirma. In our lung program, we expect to incur expenses related to the collection of prospective samples and advancing the program into product development.

***Selling and Marketing***

Selling and marketing expenses consist of personnel costs, including stock-based compensation expense, direct marketing expenses, consulting costs, and allocated overhead including rent, information technology, equipment depreciation and utilities. In addition, up-front co-promotion fees paid to Genzyme, net of amortization, are included in selling and marketing expenses. We expect our selling and marketing expenses to increase over the next 12 months primarily driven by the co-promotion fees to Genzyme, which fees increase as cash receipts from Afirma increase (test volume is increasing at a greater rate than the contractual rate reduction), the costs of hiring additional internal sales and marketing personnel associated with further penetrating the domestic market and selectively launching in international markets, and marketing and education expenses to drive market penetration and reimbursement.

***General and Administrative***

General and administrative expenses include executive, finance and accounting, human resources, billing and client services, and quality and regulatory functions. These expenses include personnel costs, including stock-based compensation expense, audit and legal expenses, consulting costs, and allocated overhead including rent, information technology, equipment depreciation and utilities. We expect to incur additional expenses over the next 12 months as a result of operating as a public company, including expenses related to compliance with the rules and regulations of the Securities and Exchange Commission and The NASDAQ Stock Market, additional insurance expenses, investor relations activities and other administrative and professional services. We also expect our general and administration expenses will increase in absolute dollars over the next 12 months as we expand our billing group to support anticipated increased demand for our tests and begin to incur expenses related to the documentation of our internal controls in connection with Section 404 of the Sarbanes-Oxley Act.

***Interest Income***

Interest income is from interest on our cash equivalents.

***Interest Expense***

Interest expense is attributable to our borrowings under the loan agreement entered into in June 2013.

***Other Income (Expense), Net***

Other income (expense), net is related primarily to the change in value of the preferred stock liability associated with our obligation to issue additional shares of Series C convertible preferred stock. In November 2012, we entered into a tranching Series C convertible preferred stock purchase agreement. In connection with the initial closing, we agreed to issue to the purchasers, and the purchasers agreed to purchase, additional shares of the Series C convertible preferred stock within a specified timeframe. We determined that the liability to issue additional Series C convertible preferred stock at a future date was a freestanding instrument that should be accounted for as a liability. Accordingly, we recorded a liability related to this instrument at the time of the initial close in November 2012, and we remeasured the liability at each reporting period with the corresponding gain or loss from the adjustment recorded as other income (expense), net through the issuance of the final Series C tranche in June 2013.

In addition, other income (expense), net includes changes in value of the preferred stock warrant liability. In June 2013, in conjunction with the execution of our loan and security agreement with a

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financial institution, we issued to the lender a warrant to purchase up to 49,602 shares of Series C convertible preferred stock with an exercise price of \$7.56 per share. Upon the draw-down in June 2013 of a \$5.0 million term loan, the warrant became exercisable for 24,801 shares. Accordingly, we recorded a liability related to this warrant at the time of the initial close in June 2013 and re-measured the liability at each reporting period with the corresponding gain or loss from the adjustment recorded as other income (expense), net through the conversion of the warrant into a warrant to purchase common stock effective upon the completion of our IPO.

**Critical Accounting Policies and Estimates**

Our management's discussion and analysis of our financial condition and results of operations is based on our audited financial statements, which have been prepared in accordance with United States generally accepted accounting principles, or U.S. GAAP. The preparation of the financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported revenue generated and expenses incurred during the reporting periods. Our estimates are based on our historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions and any such differences may be material. We believe that the accounting policies discussed below are critical to understanding our historical and future performance, as these policies relate to the more significant areas involving management's judgments and estimates.

***Revenue Recognition***

Our revenue is generated from the provision of diagnostic services using the Afirma solution. Our service is completed upon the delivery of test results to the prescribing physician which triggers the billing for the service. We recognize revenue related to billings for Medicare and commercial payers on an accrual basis, net of contractual adjustments, when there is a predictable pattern of collectability. These contractual adjustments represent the difference between the list price (the billing rate) and the reimbursement rate set by Medicare and commercial payers. Upon ultimate collection, the amount received from Medicare and commercial payers with a predictable pattern of payment is compared to previous estimates and the contractual allowance is adjusted accordingly. Until a contract has been negotiated with a commercial carrier or governmental program, the Afirma solution may or may not be covered by these entities' existing reimbursement policies. In addition, patients do not enter into direct agreements with us that commit them to pay any portion of the cost of the tests in the event that their insurance declines to reimburse us. In the absence of an agreement or other clearly enforceable legal right to demand payment, when test services are provided to patients with non-contracted insurance carriers or no insurance, the related revenue is only recognized upon the earlier of payment notification, if applicable, or cash receipt.

For all services performed, we consider whether or not the following revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured.

Persuasive evidence of an arrangement exists and delivery is deemed to have occurred upon delivery of a patient report to the prescribing physician. The assessment of the fixed or determinable nature of the fees charged for testing performed and the collectability of those fees require significant judgment by management. Management believes that these two criteria have been met when there is a contracted reimbursement rate and/or a predictable pattern of collectability with individual third-party payers and accordingly, we recognize revenue upon delivery of the patient report. Some patients have out-of-pocket costs for amounts not covered by their insurance carrier, and we may bill the patient directly for these amounts in the form of co-payments and co-insurance in accordance with their insurance carrier and

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health plans. Some payers may not cover the GEC as ordered by the prescribing physician under their reimbursement policies. We pursue reimbursement from such patients on a case-by-case basis. In the absence of contracted reimbursement coverage or a predictable pattern and history of collectability, we believe that the fee is fixed or determinable and collectability is reasonably assured only upon receipt of third-party payer notification of payment or when cash is received and accordingly, recognize revenue at that time.

We use judgment in our assessment of whether the fee is fixed or determinable and whether collectability is reasonably assured in determining when to recognize revenue in the future as we continue to gain payment experience with third-party payers and patients.

*Allowance for Doubtful Accounts*

We estimate an allowance for doubtful accounts against our individual accounts receivable based on estimates of expected payment consistent with historical payment experience. Our allowance for doubtful accounts is evaluated on a regular basis and adjusted when trends or significant events indicate that a change in estimate is appropriate. Historically, the amounts of uncollectible individual accounts receivable that have been written off have been consistent with management's expectations. Accounts receivable are written off against the allowance when the appeals process is exhausted or when there is other substantive evidence that the account will not be paid. If the financial conditions of our customers were to deteriorate resulting in an impairment of their ability to make payments, additional allowances may be required.

If the financial conditions of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Derivative Liability*

We account for derivative financial instruments as either equity or liabilities based upon the characteristics and provisions of each instrument. We recorded the preferred stock liability incurred in connection with our Series C convertible preferred stock and the preferred stock warrant liability related to the issuance of a warrant for Series C convertible preferred stock, each as a derivative financial instrument liability at their fair value on the date of issuance, and we remeasure them on each subsequent balance sheet date. The changes in fair value are recognized as a gain or loss from the adjustment to other income (expense), net in the statements of operations and comprehensive loss. We estimate the fair value of this liability using option-pricing models that include assumptions for future financings, expected volatility, expected life, yield and risk-free interest rate. The preferred stock liability was extinguished in 2013 and the warrant to purchase Series C convertible preferred stock was converted into a warrant to purchase our common stock as of the close of the IPO.

*Deferred Tax Assets*

We file U.S. federal income tax returns and tax returns in California, Texas and other states. To date, we have not been audited by the Internal Revenue Service or any state income tax authority.

As of December 31, 2013, our gross deferred tax assets were \$32.8 million. The deferred tax assets were primarily comprised of federal and state tax net operating loss and tax credit carryforwards. Utilization of the net operating loss and tax credit carryforwards may be subject to annual limitation due to historical or future ownership percentage change rules provided by the Internal Revenue Code of 1986, and similar state provisions. The annual limitation may result in the expiration of certain net operating loss and tax credit carryforwards before their utilization.

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We are required to reduce our deferred tax assets by a valuation allowance if it is more likely than not that some or all of our deferred tax assets will not be realized. We must use judgment in assessing the potential need for a valuation allowance, which requires an evaluation of both negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. In determining the need for and amount of our valuation allowance, if any, we assess the likelihood that we will be able to recover our deferred tax assets using historical levels of income, estimates of future income and tax planning strategies. As a result of historical cumulative losses and, based on all available evidence, we believe it is more likely than not that our recorded net deferred tax assets will not be realized. Accordingly, we recorded a valuation allowance against all of our net deferred tax assets at December 31, 2013. We will continue to maintain a full valuation allowance on our deferred tax assets until there is sufficient evidence to support the reversal of all or some portion of this allowance.

***Stock-based Compensation***

We recognize stock-based compensation cost for only those shares underlying stock options that we expect to vest on a straight-line basis over the requisite service period of the award. We estimate the fair value of stock options using a Black-Scholes valuation model, which requires the input of highly subjective assumptions, including the option's expected term and stock price volatility. In addition, judgment is also required in estimating the number of stock-based awards that are expected to be forfeited. Forfeitures are estimated based on historical experience at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. 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's judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future.

**Results of Operations*****Comparison of the Years Ended December 31, 2013 and 2012***

	Year Ended December 31,		Dollar	%
	2013	2012	Change	Change
	(In thousands)			
Revenue	\$ 21,884	\$ 11,628	\$ 10,256	88%
Operating expenses:				
Cost of revenue	12,607	7,584	5,023	66%
Research and development	7,810	6,608	1,202	18%
Selling and marketing	12,540	8,447	4,093	48%
General and administrative	12,100	7,918	4,182	53%
Total operating expenses	45,057	30,557	14,500	47%
Loss from operations	(23,173)	(18,929)	(4,244)	22%
Interest income	5	2	3	150%
Interest expense	(233)		(233)	N/A
Other income (expense), net	(2,179)	278	(2,457)	N/A
Net loss	\$ (25,580)	\$ (18,649)	\$ (6,931)	37%



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*Revenue*

Revenue increased \$10.3 million, or 88%, for the year ended December 31, 2013 compared to the same period in 2012 primarily as a result of a \$7.2 million increase in commercial revenue from increased reimbursement and collections and a \$3.1 million increase in Medicare revenue as a result of increased Afirma adoption.

*Cost of revenue*

Cost of revenue increased \$5.0 million, or 66%, for the year ended December 31, 2013 compared to the same period in 2012. This increase was primarily due to a \$4.7 million, or 77%, increase in variable costs that are directly related to the increase in the number of FNAs received, offset in part by continuing refinements in our testing process and economies of scale related to the increase in FNAs. FNAs received increased 23,780, or 92%, to 49,670 in the year ended December 31, 2013.

*Research and development*

Research and development expense increased \$1.2 million, or 18%, for the year ended December 31, 2013 compared to the same period in 2012. This increase was primarily due to a \$0.7 million increase in personnel expenses related to a 24% increase in headcount, and a \$0.5 million increase in licensing expenses to secure intellectual property to augment our existing thyroid patent portfolio.

*Selling and marketing*

Selling and marketing expense increased \$4.1 million, or 48%, for the year ended December 31, 2013 compared to the same period in 2012. This increase was primarily due to a \$3.0 million increase in net expense recognized under our co-promotion agreement with Genzyme, partially offset by amortization of the deferred fee, a \$0.5 million increase in personnel expenses related to a 28% increase in headcount, a \$0.5 million increase in marketing and promotional materials, and a \$0.1 million increase in consulting expenses.

*General and administrative*

General and administrative expense increased \$4.2 million, or 53%, for the year ended December 31, 2013 compared to the same period in 2012. This increase was primarily due to a \$2.0 million increase in personnel expenses related to a 63% increase in headcount, a \$1.4 million increase in professional fees primarily due to non-capitalizable IPO related audit and legal services, a \$0.4 million increase in stock-based compensation expense primarily related to 2013 option grants, a \$0.4 million increase in rent and other facilities expenses primarily due to the opening of the Austin, Texas facility, and a \$0.2 million increase in insurance expenses related to higher premiums associated with being a public company.

*Interest income*

Interest income increased 150% for the year ended December 31, 2013 compared to the same period in 2012 due primarily to the increase in cash in 2013 from the \$59.2 million in net proceeds from the IPO, \$12.9 million in net proceeds received from the sale of convertible preferred stock and \$4.9 million in net borrowings under our loan and security agreement.

*Interest expense*

Interest expense increased \$0.2 million for the year ended December 31, 2013 compared to the same period in 2012. Interest expense of \$0.2 million for the year ended December 31, 2013 is interest incurred on the initial June 2013 drawdown of \$5.0 million under our loan and security agreement. We did not have any debt in the same period in 2012.

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#### *Other income (expense), net*

Other income (expense), net, decreased \$2.5 million in the year ended December 31, 2013 compared to the same period in 2012. The decrease was primarily related to a \$2.4 million increase in the fair value of the preferred stock liability from a gain of \$0.3 million in 2012 to a loss of \$2.1 million in 2013, and a \$0.1 million increase in the fair value of the preferred stock warrant liability. As the preferred stock liability was extinguished in 2013, and the preferred stock warrant liability was converted into a warrant to purchase our common stock upon the completion of the IPO in 2013, any related expenses will not carry forward to future periods.

#### *Comparison of the Years Ended December 31, 2012 and 2011*

	Year Ended December 31,		Dollar Change	% Change
	2012	2011		
	(In thousands)			
Revenue	\$ 11,628	\$ 2,645	\$ 8,983	340%
Operating expenses:				
Cost of revenue	7,584	2,925	4,659	159%
Research and development	6,608	6,680	(72)	1%
Selling and marketing	8,447	2,934	5,513	188%
General and administrative	7,918	5,372	2,546	47%
Total operating expenses	30,557	17,911	12,646	71%
Loss from operations	(18,929)	(15,266)	(3,663)	24%
Interest expense	2	2		
Other income (expense), net	278	819	(541)	66%
Net loss	\$ (18,649)	\$ (14,445)	\$ (4,204)	29%

#### *Revenue*

Revenue increased \$9.0 million, or 340%, for the year ended December 31, 2012 compared to the same period in 2011 primarily due to a \$6.4 million increase in revenue from increased Afirma adoption, resulting in increased collections, and a \$2.6 million increase in revenue from Medicare.

#### *Cost of revenue*

Cost of revenue increased \$4.7 million, or 159%, for the year ended December 31, 2012 compared to the same period in 2011. This increase is primarily due to a \$4.3 million, or 237%, increase in variable costs which are directly related to the increase in the number of FNAs received for analysis from 6,402 in 2011 to 25,890 in 2012, offset by continuing refinements in our testing process and economies of scale related to the increase in FNAs. The remaining increase of \$0.4 million relates to increases in indirect labor costs, supplies, and depreciation and facility allocations.

#### *Research and development*

Research and development expenses were essentially flat in the year ended December 31, 2012 compared to the same period in 2011. Our research and development expenses in 2011 reflect the conclusion of clinical studies and other research and development activities supporting the commercial launch of Afirma. In 2012, our research and development expenses shifted to the development of our product pipeline as well as the continued support of Afirma.



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*Selling and marketing*

Selling and marketing expenses increased \$5.5 million, or 188%, in the year ended December 31, 2012 compared to the same period in 2011. This increase was primarily due to \$3.1 million in net expense recognized under our co-promotion agreement with Genzyme, partially offset by amortization of the deferred fee. The remaining \$2.4 million increase included a \$1.4 million increase in personnel expenses as we hired a vice president of sales and additional sales representatives in 2012, a \$0.4 million increase in marketing and promotional materials, a \$0.3 million increase in allocated information technology, facilities and other costs, and a \$0.3 million increase in travel and meetings related expenses.

*General and administrative*

The \$2.5 million, or 47%, increase in general and administrative expenses in the year ended December 31, 2012 compared to the same period in 2011 was due to a \$1.8 million increase in personnel expenses primarily from increased headcount, higher bonus payments and higher stock-based compensation expense, a \$0.3 million increase in professional fees, and a \$0.3 million increase in occupancy and equipment expenses.

*Other income (expense), net*

Other income (expense), net was \$0.8 million for the year ended December 31, 2011, and is primarily comprised of \$0.7 million related to the decrease in value of the preferred stock liability associated with our obligation to issue additional shares of Series B convertible preferred stock. In addition, \$0.1 million represents a payment made to us by Genzyme in connection with the right to negotiate an exclusive co-promotion arrangement. Other income (expense), net was \$0.3 million for the year ended December 31, 2012, which represents the decrease in value of the preferred stock liability associated with our obligation to issue additional shares of Series C convertible preferred stock.

**Liquidity and Capital Resources**

We have incurred net losses since our inception. For the years ended December 31, 2013, 2012 and 2011, we had a net loss of \$25.6 million, \$18.6 million and \$14.4 million, respectively, and we expect to incur additional losses in the foreseeable future. As of December 31, 2013, we had an accumulated deficit of \$85.6 million. To date, we have generated only limited revenue, and we may never achieve revenue sufficient to offset our expenses.

Since inception, we have received \$153.4 million in net proceeds from various sources with which to finance our operations, including net proceeds of \$78.6 million from sales of our preferred stock, net proceeds of \$59.2 million from our IPO, \$10.0 million from the Genzyme co-promotion agreement, net borrowings of \$4.9 million under our loan and security agreement, and \$0.7 million from the exercise of stock options. As of December 31, 2013 and December 31, 2012, we had \$71.2 million and \$14.0 million of cash and cash equivalents, respectively.

In June 2013, we entered into a loan and security agreement with a financial institution. This agreement provides for term loans of up to an aggregate of \$10.0 million. On entering into the agreement, we drew down an initial \$5.0 million term loan. We may request a second term loan of up to \$5.0 million on or prior to March 31, 2014. Loans drawn under the loan and security agreement will be used for working capital and general corporate purposes.

The initial term loan bears interest at a fixed rate equal to 6.06%. The second term loan, if drawn, will bear interest at a fixed rate equal to the greater of (a) 5.88% or (b) the three-year U.S. Treasury note rate, plus 5.40%. We are required to repay any outstanding principal amounts of each loan in 30 equal monthly installments beginning 18 months after the date of each borrowing. In each case, on the date of our final

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principal payment, we must also pay an end-of-term payment equal to 4.45% of the amount borrowed. We may, at our option, prepay the term loan borrowings by paying the lender a prepayment premium.

Our obligations under the loan and security agreement are secured by a security interest on substantially all of our assets, excluding our intellectual property and certain other assets. The loan and security agreement contains customary conditions to borrowing, events of default, and covenants, including covenants limiting our ability to dispose of assets, undergo a change in control, merge with or acquire other entities, incur debt, incur liens, pay dividends or other distributions to holders of our capital stock, repurchase stock and make investments, in each case subject to certain exceptions. The loan and security agreement does not require that we comply with any financial covenants.

In connection with the draw-down of the initial \$5.0 million term loan under the loan and security agreement, we issued the lender a warrant to purchase 99,206 shares of our Series C preferred stock, which became exercisable for 24,801 shares of our common stock upon completion of the IPO. The warrant will expire on the seventh anniversary of the IPO. If we draw-down the second term loan under the loan and security agreement, the warrant will become exercisable for an additional 24,801 shares on identical terms.

Our primary uses of cash are to fund our operations as we continue to grow our business. We expect to continue to incur operating losses in the near term as our operating expenses will be increased to support the growth of our business. We expect that our selling and marketing, research and development, and general and administrative expenses will continue to increase as we expand our marketing efforts and increase our internal sales force to drive increased adoption of and reimbursement for Afirma, prepare to commercialize our Afirma Malignancy Classifiers, continue our research and development efforts with respect to our lung program and further develop our product pipeline, and manage increases in billing and cash collection transactional volumes, and the costs of being a public company. Cash used to fund operating expenses is impacted by the timing of when we pay expenses, as reflected in the change in our outstanding accounts payable and accrued expenses.

We expect that our near- and longer-term liquidity requirements will continue to consist of selling and marketing expenses, research and development expenses, working capital, and general corporate expenses associated with the growth of our business. Based on our current business plan, we believe our existing cash and cash equivalents as of December 31, 2013 and our revenue from the sale of Afirma will be sufficient to meet our anticipated cash requirements for at least the next 12 months. However, we may also use cash to acquire or invest in complementary businesses, technologies, services or products that would change our cash requirements. If we are not able to generate revenue to finance our cash requirements, we will need to finance future cash needs primarily through public or private equity offerings, debt financings, borrowings or strategic collaborations or licensing arrangements. If we raise funds by issuing equity securities, dilution to stockholders may result. Any equity securities issued may also provide for rights, preferences or privileges senior to those of holders of our common stock. If we raise funds by issuing debt securities, these debt securities would have rights, preferences and privileges senior to those of holders of our common stock. The terms of debt securities or borrowings could impose significant restrictions on our operations. If we raise funds through collaborations and licensing arrangements, we might be required to relinquish significant rights to our technologies or products, or grant licenses on terms that are not favorable to us. The credit market and financial services industry have in the past, and may in the future, experience periods of upheaval that could impact the availability and cost of equity and debt financing. If we are not able to secure additional funding when needed, on acceptable terms, we may have to delay, reduce the scope of or eliminate one or more research and development programs or selling and marketing initiatives. In addition, we may have to work with a partner on one or more of our product or market development programs, which could lower the economic value of those programs to us.

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The following table summarizes our cash flows for the years ended December 31, 2013 and 2012:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Cash used in operating activities	\$ (19,159)	\$ (7,167)	\$ (13,524)
Cash used in investing activities	(1,282)	(1,462)	(331)
Cash provided by financing activities	77,659	15,065	18,646

**Cash Flows from Operating Activities**

Cash used in operating activities for the year ended December 31, 2013 was \$19.2 million. The net loss of \$25.6 million was offset by non-cash charges of \$2.1 million for the change in the value of the preferred stock liability, \$2.5 million in amortization of the deferred fee received from Genzyme, \$1.2 million of stock based compensation, \$1.0 million of depreciation and amortization, \$0.1 million of bad debt expense, a \$0.1 million charge for the change in value of the preferred stock warrant liability, and \$0.1 million for non-cash interest on the outstanding debt. The increase in net changes in assets and liabilities of \$4.3 million was primarily due to a \$7.2 million increase in accounts payable and accrued liabilities due to timing of payments offset by a \$2.9 million increase in assets, including a \$0.7 million increase in prepaid expenses due primarily to increased public company related prepaid insurance premiums, a \$1.5 million increase in supply inventory due to the increase in volume of testing performed, and a \$0.7 million increase in accounts receivable due to increased revenues from Medicare.

Cash used in operating activities for the year ended December 31, 2012 was \$7.2 million. The net loss of \$18.6 million was offset by non-cash charges of \$0.9 million of stock- and equity-based compensation, \$0.7 million for depreciation and amortization, \$0.3 million for the change in value of the preferred stock liability and \$0.2 million of bad debt expense. The increase in net operating assets of \$12.3 million was primarily due to the \$10.0 million deferred payment from Genzyme, of which we amortized \$2.4 million as of December 31, 2012. Accounts payable and accrued liabilities increased \$3.9 million due to the growth in our operations and the timing of our payments. Accounts receivable increased by \$0.6 million due to the increase in accrued revenue in 2012 as we had only begun to sell Afirma in 2011. In addition, there was a \$0.8 million increase in supplies inventory related to increased test demand.

Cash used in operating activities for the year ended December 31, 2011 was \$13.5 million. The net loss of \$14.4 million was offset by non-cash charges of \$0.7 million of stock- and equity-based compensation, \$0.7 million for the change in value of the preferred stock liability, \$0.6 million of depreciation and amortization, \$0.2 million of bad debt expense and a \$0.2 million loss on the disposal of property and equipment. The decrease in net operating assets of \$0.1 million was primarily due to the increase in accounts receivable as 2011 was our first year with revenue, and an increase of \$0.1 million in supplies inventory, offset by an increase in accounts payable and accrued liabilities of \$0.6 million due to the growth in our operations and the timing of payments.

**Cash Flows from Investing Activities**

Cash used in investing activities is primarily related to the acquisition of property and equipment of \$1.3 million, \$1.5 million and \$0.3 million for the years ended December 31, 2013, 2012 and 2011, respectively. Purchases of property and equipment were primarily for leasehold improvements and laboratory equipment.

**Cash Flows from Financing Activities**

Cash provided by financing activities for the year ended December 31, 2013 of \$77.7 million was primarily from the receipt of \$59.9 million in net proceeds from the issuance of common stock in connection with our IPO and from the exercise of options to purchase our common stock, the receipt of

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\$12.9 million in net proceeds from the sale of our convertible preferred stock, and net borrowings of \$4.9 million under the loan and security agreement.

Cash provided by financing activities for the years ended December 31, 2012 and 2011 of \$15.1 million and \$18.6 million, respectively, were primarily due to the net proceeds from the sale of our convertible preferred stock.

**Contractual Obligations**

The following table summarizes certain contractual obligations as of December 31, 2013 (in thousands):

	Payments Due by Period				Total
	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years	
Operating lease obligations	\$ 938	\$ 1,402	\$ 352	\$	\$ 2,692
Long-term debt obligations		3,938	1,062		5,000
Interest on debt	307	388	242		937
Volume purchase commitment	125	125			250
<b>Total</b>	<b>\$ 1,370</b>	<b>\$ 5,853</b>	<b>\$ 1,656</b>	<b>\$</b>	<b>\$ 8,879</b>

In February 2010, we entered into a non-cancelable lease agreement for our headquarters and laboratory space in South San Francisco, California. The lease expires in March 2016.

In November 2012, we entered into a non-cancelable lease agreement commencing February 2013 for our laboratory and office space in Austin, Texas. The lease expires in July 2018.

In June 2013, we entered into a \$10.0 million loan and security agreement with a financial institution, and drew down an initial term loan of \$5.0 million. We are required to pay interest only on this loan for the first 18 months and then will begin paying principal and interest over the subsequent 30-month period.

In February 2013, we entered into a non-cancelable volume purchase agreement with a supplier to purchase a minimum quantity of supplies inventory at a fixed price. The total amount of the arrangement was \$0.4 million.

**Off-balance Sheet Arrangements**

We have not entered into any off-balance sheet arrangements.

**JOBS Act Accounting Election**

We are an emerging growth company, as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act. Under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards issued subsequent to the enactment of the JOBS Act until such time as those standards apply to private companies. We have irrevocably elected not to avail ourselves of this exemption from new or revised accounting standards and, therefore, will be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

**Recent Accounting Pronouncements**

In July 2013, Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2013-11, *Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)*. The amendments in this ASU provide guidance on the financial statements presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit





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carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU do not require new recurring disclosures and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. We are currently assessing the impact of this ASU on our financial statements.

In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This ASU requires reporting and disclosure about changes in accumulated other comprehensive income balances and reclassifications out of accumulated other comprehensive income. We adopted this guidance as of January 1, 2013 on a prospective basis and the adoption did not have a material effect on our financial statements as we do not have comprehensive income (loss).

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We are exposed to market risks in the ordinary course of our business. These risks primarily relate to interest rates. We had cash and cash equivalents of \$71.2 million and \$14.0 million as of December 31, 2013 and December 31, 2012, respectively, which consist of bank deposits and money market funds. Such interest-bearing instruments carry a degree of risk; however, we have not been exposed to, nor do we anticipate being exposed to, material risks due to changes in interest rates. A hypothetical 10% change in interest rates during any of the periods presented would not have had a material impact on our audited financial statements.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**Veracyte, Inc.  
Index to Financial Statements**

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<u>Statements of Operations and Comprehensive Loss for the Years Ended December 31, 2013, 2012 and 2011</u>	<u>82</u>
<u>Statements of Convertible Preferred Stock and Stockholders' Equity (Deficit) for the Years Ended December 31, 2013, 2012 and 2011</u>	<u>83</u>
<u>Statements of Cash Flows for the Years Ended December 31, 2013, 2012 and 2011</u>	<u>84</u>
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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of  
Veracyte, Inc.

In our opinion, the accompanying balance sheets and the related statements of operations and comprehensive loss, of convertible preferred stock and stockholders' deficit, and of cash flows present fairly, in all material respects, the financial position of Veracyte, Inc. at December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. 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 of these statements 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

San Jose, California  
March 20, 2014

Table of Contents**VERACYTE, INC.****Balance Sheets****(In thousands, except share and per share amounts)**

	<b>As of December 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 71,220	\$ 14,002
Accounts receivable, net of allowance of \$107 and \$222 as of December 31, 2013 and 2012	1,143	569
Supplies inventory	2,567	1,050
Prepaid expenses and other current assets	1,477	710
Restricted cash		50
Total current assets	76,407	16,381
Property and equipment, net	2,952	2,446
Restricted cash	118	118
Other assets	153	122
Total assets	\$ 79,630	\$ 19,067
<b>Liabilities, Convertible Preferred Stock, and Stockholders' Equity (Deficit)</b>		
Current liabilities:		
Accounts payable	\$ 5,294	\$ 1,888
Accrued liabilities	7,594	4,020
Deferred Genzyme co-promotion fee	2,500	2,500
Preferred stock liability		583
Total current liabilities	15,388	8,991
Long-term debt, net of current portion	4,899	
Deferred rent, net of current portion	286	61
Deferred Genzyme co-promotion fee, net of current portion	2,614	5,114
Total liabilities	23,187	14,166
Commitments and contingencies (Note 8)		
Convertible preferred stock, \$0.001 par value; 0 and 59,147,999 shares authorized, 0 and 53,084,507 shares issued and outstanding as of December 31, 2013 and December 31, 2012; aggregate liquidation value of \$0 and \$65,835 as of December 31, 2013 and 2012		63,372
Stockholders' deficit:		
Common stock, \$0.001 par value; 125,000,000 and 77,000,000 shares authorized, 21,143,313 and 667,684 shares issued and outstanding as of December 31, 2013 and 2012	21	1
Additional paid-in capital	142,071	1,597

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Preferred stock, \$0.001 par value; 5,000,000 and 0 shares authorized, 0 shares issued and outstanding as of  
December 31, 2013 and 2012

Accumulated deficit	(85,649)	(60,069)
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Total stockholders' equity (deficit)	56,443	(58,471)
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Total liabilities, convertible preferred stock, and stockholders' equity (deficit)	\$ 79,630	\$ 19,067
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The accompanying notes are an integral part of these financial statements.

Table of Contents**VERACYTE, INC.****Statements of Operations and Comprehensive Loss****(In thousands, except share and per share amounts)**

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Revenue	\$ 21,884	\$ 11,628	\$ 2,645
Operating expenses:			
Cost of revenue	12,607	7,584	2,925
Research and development	7,810	6,608	6,680
Selling and marketing	12,540	8,447	2,934
General and administrative	12,100	7,918	5,372
<b>Total operating expenses</b>	<b>45,057</b>	<b>30,557</b>	<b>17,911</b>
Loss from operations	(23,173)	(18,929)	(15,266)
Interest income	5	2	2
Interest expense	(233)		
Other income (expense), net	(2,179)	278	819
<b>Net loss and comprehensive loss</b>	<b>\$ (25,580)</b>	<b>\$ (18,649)</b>	<b>\$ (14,445)</b>
<b>Net loss per common share, basic and diluted</b>	<b>\$ (6.15)</b>	<b>\$ (28.68)</b>	<b>\$ (24.90)</b>
Shares used to compute net loss per common share, basic and diluted	4,158,664	650,333	580,061

The accompanying notes are an integral part of these financial statements.

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## VERACYTE, INC.

## Statements of Convertible Preferred Stock and Stockholders' Equity (Deficit)

(In thousands, except share and per share amounts)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount			
Balance January 1, 2011	30,249,334	\$ 30,674	556,844	\$ 1	\$ 163	\$ (26,975)	\$ (26,811)
Issuance of Series B convertible preferred stock in February 2011 at \$1.25 per share, net of issuance costs of \$1	7,449,335	9,311					
Issuance of Series B convertible preferred stock in July 2011 at \$1.25 per share, net of issuance costs of \$1	7,449,330	9,311					
Common stock issued on exercise of stock options			38,097		24		24
Stock-based compensation expense (employee)					378		378
Stock-based compensation expense (non-employee)					88		88
Net loss and comprehensive loss						(14,445)	(14,445)
Balance December 31, 2011	45,147,999	\$ 49,296	594,941	\$ 1	\$ 653	\$ (41,420)	\$ (40,766)
Issuance of Series C convertible preferred stock in November and December 2012 at \$1.89 per share, net of issuance costs of \$63 and \$861 preferred stock liability	7,936,508	14,076					
Common stock issued on exercise of stock options			72,743		76		76
Stock-based compensation expense (employee)					590		590
Stock-based compensation expense (non-employee)					85		85
Equity-based compensation					193		193
Net loss and comprehensive loss						(18,649)	(18,649)
Balance December 31, 2012	53,084,507	\$ 63,372	667,684	\$ 1	\$ 1,597	\$ (60,069)	\$ (58,471)
Issuance of Series C convertible preferred stock in June 2013 at \$1.89 per share, net of issuance costs of \$53	6,904,761	12,997					
Extinguishment of preferred stock liability		2,653					
Issuance of common stock on exercise of stock options			377,966		552		552
Issuance of common stock in initial public offering, net of discounts and commissions of \$4,642 and issuance costs of \$2,507			5,100,351	5	59,151		59,156
Conversion of preferred stock into common stock upon initial public offering	(59,989,268)	(79,022)	14,997,312	15	79,007		79,022
Reclassification of preferred stock warrant liability into additional paid-in capital upon initial public offering					261		261
Stock-based compensation expense (employee)					1,041		1,041
Stock-based compensation expense (non-employee)					206		206
Equity-based compensation					259		259
Common stock subject to repurchase					(3)		(3)
Net loss and comprehensive loss						(25,580)	(25,580)
Balance December 31, 2013			21,143,313	\$ 21	\$ 142,071	\$ (85,649)	\$ 56,443

The accompanying notes are an integral part of these financial statements.





Table of Contents**VERACYTE, INC.****Statements of Cash Flows****(In thousands)**

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>Operating activities</b>			
Net loss	\$ (25,580)	\$ (18,649)	\$ (14,445)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	999	706	611
Bad debt expense	109	225	235
Loss on write-off of property and equipment			215
Genzyme co-promotion fee amortization	(2,500)	(2,386)	
Stock-based compensation	1,247	675	466
Equity-based compensation		259	193
Change in value of preferred stock liability	2,070	(278)	(719)
Change in value of preferred stock warrant liability	86		
Amortization of debt discount and issuance costs	56		
Interest on debt balloon payment	42		
Changes in operating assets and liabilities:			
Accounts receivable	(683)	(565)	(463)
Supplies inventory	(1,517)	(771)	(143)
Prepaid expenses and current other assets	(722)	(191)	(117)
Other assets	24	(119)	(1)
Accounts payable	3,348	1,348	116
Accrued liabilities and deferred rent	3,862	2,579	528
Deferred Genzyme co-promotion fee		10,000	
Net cash used in operating activities	(19,159)	(7,167)	(13,524)
<b>Investing activities</b>			
Purchases of property and equipment	(1,332)	(1,462)	(276)
Change in restricted cash	50		(55)
Net cash used in investing activities	(1,282)	(1,462)	(331)
<b>Financing activities</b>			
Proceeds from the issuance of long-term debt, net of debt issuance costs	4,877		
Proceeds from issuance of convertible preferred stock, net of issuance costs	12,945	14,989	18,622
Proceeds from issuance of common stock in initial public offering, gross	66,304		
Commissions and issuance costs relating to the initial public offering	(7,019)		
Proceeds from the exercise of common stock options	552	76	24
Net cash provided by financing activities	77,659	15,065	18,646
<b>Net increase in cash and cash equivalents</b>	<b>57,218</b>	<b>6,436</b>	<b>4,791</b>

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<b>Cash and cash equivalents at beginning of period</b>	14,002	7,566	2,775
<b>Cash and cash equivalents at end of period</b>	\$ 71,220	\$ 14,002	\$ 7,566

**Supplementary cash flow information of non-cash investing and financing activities:**

Purchases of property and equipment included in accounts payable and accrued liabilities	\$ 25	\$ 109	\$ 106
Non-cash purchases of property and equipment	\$ 257	\$	\$
Preferred stock liability	\$	\$ 861	\$
Transfer of preferred stock liability to equity	\$ 2,653	\$	\$
Convertible preferred stock issuance costs included in accounts payable	\$	\$ 52	\$
Preferred stock warrants	\$ 175	\$	\$
Conversion of preferred stock warrant liability to common stock warrants	\$ 261	\$	\$
Conversion of convertible preferred stock to common stock	\$ 79,022	\$	\$
IPO costs included in accounts payable and accrued liabilities	\$ 129	\$	\$
Cash paid for interest on debt	\$ 132	\$	\$
Transfer of equity-based compensation from liabilities to equity	\$ 259	\$ 193	\$

The accompanying notes are an integral part of these financial statements.

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**VERACYTE, INC.**

**Notes to Audited Financial Statements**

**1. Organization and Description of Business**

Veracyte, Inc. (the "Company") was incorporated in the state of Delaware on August 15, 2006 as Calderome, Inc. Calderome operated as an incubator until early 2008. On March 4, 2008, the Company changed its name to Veracyte, Inc. Veracyte is a diagnostics company pioneering the field of molecular cytology to improve patient outcomes and lower healthcare costs. The Company specifically targets diseases that often require invasive procedures for an accurate diagnosis diseases where many healthy patients undergo costly interventions that ultimately prove unnecessary. The Company improves the accuracy of diagnosis at an earlier stage of patient care by deriving clinically actionable genomic information from cytology samples collected in an outpatient setting. The Company's first commercial solution, the Afirma Thyroid FNA Analysis, includes as its centerpiece the Gene Expression Classifier ("GEC"). The GEC helps physicians reduce the number of unnecessary surgeries by employing a proprietary 142-gene signature to preoperatively determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign. The Company's operations are based in South San Francisco, California and Austin, Texas, and it operates in one segment in the United States.

***Reverse Stock Split***

On October 9, 2013, the Company filed a Certificate of Amendment to its Fourth Amended and Restated Certificate of Incorporation to effect a four-for-one reverse stock split of its outstanding common stock. The par value per share and the authorized number of shares of common stock and preferred stock were not adjusted as a result of the reverse stock split. All issued and outstanding shares of common stock, options to purchase common stock and related per share amounts contained in the financial statements have been retroactively adjusted to reflect the reverse stock split for all periods presented. A proportional adjustment to the conversion ratio for each series of convertible preferred stock was also effected in connection with the reverse stock split. The financial statements have not been retroactively adjusted to give effect to the conversion of the preferred stock into 0.25 of a share of common stock upon the closing of the IPO.

***Initial Public Offering***

On November 4, 2013, the Company completed an initial public offering ("IPO") of its common stock. In connection with its IPO, the Company issued and sold 5,000,000 shares of its common stock at a price to the public of \$13.00 per share. Another 100,351 shares were issued on December 2, 2013. As a result of the IPO, the Company received approximately \$59.2 million in net proceeds, after deducting underwriting discounts and commissions of \$4.6 million and offering expenses of \$2.5 million payable by the Company. In connection with the IPO, the Company's outstanding shares of convertible preferred stock were automatically converted into 14,997,312 shares of common stock.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The Company's financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP").

***Use of Estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****2. Summary of Significant Accounting Policies (Continued)**

contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant items subject to such estimates include: revenue recognition; contractual allowances; allowance for doubtful accounts; the useful lives of property and equipment; the recoverability of long-lived assets; the determination of fair value of the Company's common stock, stock options, preferred stock liability; income tax uncertainties, including a valuation allowance for deferred tax assets; and contingencies. The Company bases these estimates on historical and anticipated results, trends, and various other assumptions that the Company believes are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses that are not readily apparent from other sources. Actual results could differ from those estimates and assumptions.

***Concentrations of Credit Risk and Other Risks and Uncertainties***

The Company's cash and cash equivalents are deposited with one major financial institution in the United States of America. Deposits in this institution may exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Several of the components of the Company's sample collection kit and test reagents are obtained from single-source suppliers. If these single-source suppliers fail to satisfy the Company's requirements on a timely basis, it could suffer delays in being able to deliver its diagnostic solution, a possible loss of revenue, or incur higher costs, any of which could adversely affect its operating results.

The Company is also subject to credit risk from its accounts receivable related to its sales of Afirma. The Company generally does not perform evaluations of customers' financial condition and generally does not require collateral. All of the Company's accounts receivables are derived from sales of Afirma in the United States.

Through December 31, 2013, all of the Company's revenues are derived from the sale of Afirma. The Company's solution to date has been delivered primarily to physicians in the United States. The Company's significant third-party payers and their related revenue as a percentage of total revenue are as follows:

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
Medicare	32%	34%
Aetna	9%	13%
UnitedHealthcare	18%	12%
	59%	59%

Accounts receivable from Medicare amounted to 78% and 87% of accounts receivable as of December 31, 2013 and 2012. No other third-party payer represented more than 10% of the Company's accounts receivable balances for these periods.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****2. Summary of Significant Accounting Policies (Continued)*****Cash Equivalents***

Cash equivalents consist of short-term, highly liquid investments with original maturities of three months or less from the date of purchase. Cash equivalents consist primarily of amounts invested in money market accounts.

***Restricted Cash***

Deposits of \$118,000 and \$168,000 as of December 31, 2013 and 2012, respectively, were restricted from withdrawal and held by a bank in the form of certificates of deposit and collateral for letters of credit. The balance as of December 31, 2013 and 2012 consists of a letter of credit totaling \$118,000 held as security for the lease of the Company's office space in South San Francisco, California, and in 2012 the Company also had a certificate of deposit of \$50,000 held as collateral for payment of the Company's credit cards.

***Allowance for Doubtful Accounts***

The Company estimates an allowance for doubtful accounts against its individual accounts receivable based on estimates of expected reimbursement consistent with historical payment experience in relation to the amounts billed. Bad debt expense is included in general and administrative expense on the Company's statements of operations and comprehensive loss. Accounts receivable are written off against the allowance when there is other substantive evidence that the account will not be paid. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payment, additional allowances may be required.

	As of December 31,	
	2013	2012
	(In thousands)	
Beginning balance	\$ 222	\$ 235
Charged to expense	109	225
Write-offs, net of recoveries	(224)	(238)
Ending balance	\$ 107	\$ 222

***Supplies Inventory***

Supplies inventory consists of test reagents and other consumables used in the sample collection kits and in the GEC and are valued at the lower of cost or market value. Cost is determined using actual costs on a first-in, first-out basis.

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally between three and five years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the term of the lease. Maintenance and repairs are charged to expense as incurred, and improvements and betterments are capitalized. When assets are retired or otherwise disposed of, the cost and accumulated depreciation are removed from the



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**VERACYTE, INC.**

**Notes to Audited Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

balance sheet and any resulting gain or loss is reflected in the statements of operations and comprehensive loss in the period realized.

***Internal-use Software***

The Company capitalizes third-party costs incurred in the application development stage to design and implement the software used in the GEC. Costs incurred in the development of application of the software are capitalized and amortized over an estimated useful life of three years on a straight line basis.

During the years ended December 31, 2013 and 2012, the Company capitalized \$212,000 and \$173,000 of software development costs. Amortization expense totaled \$108,000 and \$47,000, for the years ended December 31, 2013 and 2012, respectively. The total cost, accumulated depreciation and net book value was \$482,000, \$195,000 and \$287,000 at December 31, 2013, and was \$271,000, \$87,000 and \$184,000 at December 31, 2012 and are included in property and equipment in the Company's balance sheets.

***Long-lived Assets***

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. An impairment loss is recognized when the total of estimated future undiscounted cash flows, expected to result from the use of the asset and its eventual disposition, are less than its carrying amount. Impairment, if any, would be assessed using discounted cash flows or other appropriate measures of fair value. There were no impairments for the years ended December 31, 2013 and 2012.

***Bonus Accruals***

The Company accrues for liabilities under discretionary employee and executive bonus plans. These estimated compensation liabilities are based on progress against corporate objectives approved by the Board of Directors, compensation levels of eligible individuals, and target bonus percentage levels. The Board of Directors and the Compensation Committee of the Board of Directors review and evaluate the performance against these objectives and ultimately determine what discretionary payments are made. As of December 31, 2013 and 2012, the Company accrued \$1.1 million and \$0.7 million, respectively, for liabilities associated with these employee and executive bonus plans. As more fully discussed in Note 13 to the financial statements, a portion of the 2012 bonus accruals was settled with equity awards issued subsequent to the 2012 fiscal year end.

***Fair Value of Financial Instruments***

The carrying amounts of certain financial instruments including cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued liabilities approximate fair value due to their relatively short maturities.

***Revenue Recognition***

The Company's revenue is generated from the provision of diagnostic services using the Afirma solution. The Company's service is completed upon the delivery of test results to the prescribing physician which triggers the billing for the service. The Company recognizes revenue related to billings for Medicare and commercial carriers on an accrual basis, net of contractual adjustments, when there is a predictable



**VERACYTE, INC.**

**Notes to Audited Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

pattern of collectability. These contractual adjustments represent the difference between the list price (the billing rate) and the reimbursement rate set by Medicare or commercial payers. Upon ultimate collection, the amount received from Medicare and commercial payers with a predictable pattern of payment is compared to previous estimates and the contractual allowance is adjusted accordingly. Until a contract has been negotiated with a commercial carrier or governmental program, the Afirma solution may or may not be covered by these entities' existing reimbursement policies. In addition, patients do not enter into direct agreements with the Company that commit them to pay any portion of the cost of the tests in the event that their insurance declines to reimburse the Company. In the absence of an agreement with the patient or other clearly enforceable legal right to demand payment, the related revenue is only recognized upon the earlier of payment notification, if applicable, or cash receipt.

For all services performed, the Company considers whether or not the following revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured.

Persuasive evidence of an arrangement exists and delivery is deemed to have occurred upon delivery of a patient report to the prescribing physician. The assessment of the fixed or determinable nature of the fees charged for diagnostic testing performed and the collectability of those fees require significant judgment by management. Management believes that these two criteria have been met when there is contracted reimbursement coverage and/or a predictable pattern of collectability with individual third-party payers and accordingly, recognizes revenue upon delivery of the patient report. Some patients have out-of-pocket costs for amounts not covered by their insurance carrier, and the Company may bill the patient directly for these amounts in the form of co-payments and co-insurance in accordance with their insurance carrier and health plans. Some payers may not cover the Company's GEC as ordered by the prescribing physician under their reimbursement policies. The Company pursues reimbursement from such patients on a case-by-case basis. In the absence of contracted reimbursement coverage or a predictable pattern and history of collectability, the Company believes that the fee is fixed or determinable and collectability is reasonably assured only upon receipt of third-party payer notification of payment or when cash is received and accordingly, recognizes revenue at that time.

***Cost of Revenue***

Cost of revenue is expensed as incurred and includes material and service costs related to the initial cytopathology testing performed by a third-party pathology group, direct labor costs, equipment and infrastructure expenses associated with testing tissue samples, shipping charges to transport samples, and allocated overhead including rent, information technology, equipment depreciation and utilities.

***Research and Development***

Research and development costs are charged to operations as incurred. Research and development costs include, but are not limited to, payroll and personnel-related expenses, stock-based compensation expense, prototype materials, laboratory supplies, consulting costs, costs associated with setting up and conducting clinical studies at domestic and international sites, and allocated overhead including rent, information technology, equipment depreciation and utilities.

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**VERACYTE, INC.**

**Notes to Audited Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

***Income Taxes***

The Company accounts for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company assesses 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. The Company's assessment of 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 percent likely of being realized upon ultimate settlement. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and the Company will determine whether (i) the factors underlying the sustainability assertion have changed and (ii) the amount of the recognized tax benefit is still appropriate. The recognition and measurement of tax benefits requires significant judgment. Judgments concerning the recognition and measurement of a tax benefit may change as new information becomes available.

***Stock-based Compensation***

Stock-based compensation expense for equity instruments issued to employees is measured based on the grant-date fair value of the awards. The fair value of each employee stock option is estimated on the date of grant using the Black-Scholes option-pricing valuation model. The Company recognizes compensation costs on a straight-line basis for all employee stock based compensation awards that are expected to vest over the requisite service period of the awards, which is generally the awards' vesting period. Forfeitures are required to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Equity instruments issued to non-employees are valued using the Black-Scholes option-pricing valuation model and are subject to remeasurement as the underlying equity instruments vest.

***Net Loss per Common Share***

Basic net loss per common share is calculated by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding during the period, without consideration of common stock equivalents. Diluted net loss per common share is computed by dividing net loss attributable to common stockholders by the weighted-average number of common share equivalents outstanding for the period determined using the treasury stock method. Potentially dilutive securities consisting of convertible preferred stock and options to purchase common stock are considered to be common stock equivalents and were excluded from the calculation of diluted net loss per common share because their effect would be anti-dilutive for all periods presented.

***Recent Accounting Pronouncements***

In July 2013, Financial Accounting Standards Board ("FASB"), issued Accounting Standards Update ("ASU"), No. 2013-11, *Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)*. The amendments in this ASU provide guidance on the financial statements presentation of an

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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**2. Summary of Significant Accounting Policies (Continued)**

unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU do not require new recurring disclosures and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company is currently assessing the impact of this ASU on its financial statements.

In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This ASU requires reporting and disclosure about changes in accumulated other comprehensive income balances and reclassifications out of accumulated other comprehensive income. The Company adopted this guidance as of January 1, 2013 on a prospective basis and its adoption did not have a material effect on its financial statements as the Company does not have comprehensive income (loss).

**3. Net Loss Per Common Share**

The following table presents the calculation of basic and diluted net loss per common share for the years ended December 31, 2013, 2012 and 2011 (in thousands, except share and per share amounts):

	Year Ended December 31,		
	2013	2012	2011
Net loss	\$ (25,580)	\$ (18,649)	\$ (14,445)
Shares used to compute net loss per common share, basic and diluted	4,158,664	650,333	580,061
Net loss per common share, basic and diluted	\$ (6.15)	\$ (28.68)	\$ (24.90)

The following outstanding shares of common stock equivalents have been excluded from diluted net loss per common share for the years ended December 31, 2013 and 2012 because their inclusion would be anti-dilutive:

	Year Ended December 31,	
	2013	2012
Shares of common stock subject to outstanding options	2,359,287	2,227,669
Shares of common stock issuable upon conversion of preferred stock		13,271,122
Shares of common stock issuable upon exercise of warrants	24,801	
Total shares of common stock equivalents	2,384,088	15,498,791



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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**4. Balance Sheet Components***Property and Equipment, Net*

Property and equipment consisted of the following (in thousands):

	Year Ended December 31,	
	2013	2012
Leasehold improvements	\$ 779	\$ 341
Laboratory equipment	2,946	2,061
Computer equipment	645	526
Software, including software developed for internal use	901	554
Furniture and fixtures	189	81
Construction-in-process	307	699
<b>Total property and equipment, at cost</b>	<b>5,767</b>	<b>4,262</b>
Accumulated depreciation and amortization	(2,815)	(1,816)
<b>Total property and equipment, net</b>	<b>\$ 2,952</b>	<b>\$ 2,446</b>

Depreciation and amortization expense was \$999,000, \$706,000 and \$611,000 for the years ended December 31, 2013, 2012 and 2011, respectively, and was recorded in the statements of operations and comprehensive loss as follows (in thousands):

	Year Ended December 31,		
	2013	2012	2011
Cost of revenue	\$ 593	\$ 401	\$ 397
Research and development	179	184	162
Selling and marketing	54	46	21
General and administrative	173	75	31
<b>Total depreciation and amortization expense</b>	<b>\$ 999</b>	<b>\$ 706</b>	<b>\$ 611</b>

*Accrued Liabilities*

Accrued liabilities consisted of the following (in thousands):

	Year Ended December 31,	
	2013	2012

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Accrued compensation expenses	\$ 1,962	\$ 1,360
Accrued consulting fees	7	28
Accrued legal and professional fees	62	84
Accrued other	562	373
Accrued Genzyme co-promotion fees	4,915	2,175
Deferred rent short-term	86	
Total accrued liabilities	\$ 7,594	\$ 4,020

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****5. Fair Value Measurements**

The Company records its financial assets and liabilities at fair value. The carrying amounts of certain financial instruments of the Company, including cash and cash equivalents, prepaid expenses and other current assets, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities. The carrying value of debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. The accounting guidance for fair value provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The accounting guidance establishes a three-tiered hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value as follows:

Level I: Inputs which include quoted prices in active markets for identical assets and liabilities.

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

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

The following table sets forth the fair value of the Company's financial assets and liabilities measured on a recurring basis, as of December 31, 2013 and 2012 (in thousands):

	As of December 31, 2013			
	Level I	Level II	Level III	Total
<b>Financial Assets:</b>				
Money market funds	\$ 69,972	\$	\$	\$ 69,972
<b>Total financial assets</b>	<b>\$ 69,972</b>	<b>\$</b>	<b>\$</b>	<b>\$ 69,972</b>

	As of December 31, 2012			
	Level I	Level II	Level III	Total
<b>Financial Assets:</b>				
Money market funds	\$ 12,830	\$	\$	\$ 12,830
<b>Total financial assets</b>	<b>\$ 12,830</b>	<b>\$</b>	<b>\$</b>	<b>\$ 12,830</b>

Financial Liabilities:

Preferred stock liability	\$	\$	\$	583	\$	583
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Total financial liabilities	\$	\$	\$	583	\$	583
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Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****5. Fair Value Measurements (Continued)**

The Company's Level 3 liabilities consist of a preferred stock liability (see Note 11). The following table sets forth a summary of the changes in the fair value of the Company's Level 3 financial liabilities, which are measured on a recurring basis (in thousands):

	<b>December 31,</b>	
	<b>2013</b>	<b>2012</b>
Beginning balance	\$ 583	\$
Fair value of preferred stock liability		861
Change in fair value of preferred stock liability recorded as other expense, net	2,070	(278)
Settlement of preferred stock liability	(2,653)	
Fair value of preferred stock warrant liability	175	
Change in fair value of preferred stock warrant liability recorded as other expense, net	86	
Conversion of preferred stock warrant liability	(261)	
Ending balance	\$	\$ 583

In November 2012, the Company recorded a preferred stock liability as investors received the right to purchase from the Company, on the same terms, additional shares of Series C convertible preferred stock, in a second tranche. As the investors held a majority of the board seats, the decision to complete the second tranche was deemed to be outside the control of the Company. The preferred stock liability was valued using the option-pricing method, which resulted in an initial fair value of \$0.9 million for the Company's obligation to sell the convertible preferred stock. In June 2013, the Company settled the preferred stock liability upon completion of the sale of the second tranche of Series C convertible preferred stock. Immediately prior to settlement, the Company revalued the preferred stock liability to \$2.7 million and recorded other expense of \$2.1 million related to the change in value of the liability through that date. The preferred stock liability was valued using the option-pricing method with the following assumptions: 100% probability of success of the second tranche, fair value of Series C preferred stock of \$2.39, a term of 0.003 years and expected volatility of 36.4%.

**6. Genzyme Co-promotion Agreement**

In May 2011, the Company received \$100,000 from Genzyme Corporation ("Genzyme") in connection with an extension of an exclusive right to negotiate a co-promotion agreement.

In January 2012, the Company and Genzyme executed a co-promotion agreement for the co-exclusive rights and license to promote and market the Company's Afirma thyroid cancer solution in the United States and in 40 named countries. In exchange, the Company received a \$10.0 million co-promotion fee from Genzyme in February 2012. The Company may receive an additional \$3.0 million in payments, \$600,000 for each country outside of the United States in which the Company obtains marketing authorization and achieves a specified level of reimbursement, for up to five countries. Under the terms of the agreement, Genzyme will receive a percentage of cash receipts that the Company has received related to Afirma as co-promotion fees. The percentage was 50% in 2012, 40% beginning in January 2013 and will be reduced to 32% beginning on March 1, 2014 and thereafter. Genzyme will also spend up to \$500,000 for qualifying clinical development activities in countries that require additional testing for approval. This obligation expires in July 2014. The agreement expires in January 2027 and either party may terminate the

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****6. Genzyme Co-promotion Agreement (Continued)**

agreement at any time and with six months prior notice. The Company is amortizing the co-promotion fee over a four-year period, which is management's best estimate of the life of the agreement, in part because after that period either party may terminate the agreement without penalty. The Company incurred \$8.6 million and \$5.5 million in co-promotion expense in the years ended December 31, 2013 and 2012, respectively, which is included in the statements of operations and comprehensive loss. The Company amortized \$2.5 million and \$2.4 million of the \$10.0 million up-front co-promotion fee in the years ended December 31, 2013 and 2012, which is reflected as a reduction to selling and marketing expenses in the statements of operations and comprehensive loss.

The unamortized balance of the co-promotion fee is reflected on the Company's balance sheet as follows (in thousands):

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Current liabilities:</b>		
Deferred Genzyme co-promotion fee	\$ 2,500	\$ 2,500
<b>Long-term liabilities:</b>		
Deferred Genzyme co-promotion fee, net of current portion	2,614	5,114
<b>Total</b>	<b>\$ 5,114</b>	<b>\$ 7,614</b>

**7. Thyroid Cytopathology Partners**

In 2010, the Company entered into an arrangement with Pathology Resource Consultants, P.A. ("PRC") to set up and manage a specialized pathology practice to provide testing services to the Company. There is no direct monetary compensation from the Company to PRC as a result of this arrangement. The Company's service agreement with the specialized pathology practice, Thyroid Cytopathology Partners ("TCP"), is effective through December 31, 2015, unless terminated earlier, and renews annually thereafter. Under the service agreement, Veracyte pays TCP based on a fixed price per test schedule, which is reviewed periodically for changes in market pricing. Subsequent to December 2012, an amendment to the service agreement allows TCP to use a portion of Veracyte's facility in Austin, Texas. Beginning in May 2013, TCP reimburses the Company for a proportionate share of the Company's rent and related operating expense costs for the leased facility. The Company does not have an ownership interest in or provide any form of financial or other support to TCP. The Company has concluded that TCP represents a variable interest entity and that the Company is not the primary beneficiary as it does not have the ability to direct the activities that most significantly impact TCP's economic performance. Therefore, the Company does not consolidate TCP. All amounts paid to TCP under the service agreement are expensed as incurred and included in cost of revenue in the statements of operations and comprehensive loss. All amounts to be received from TCP will be recorded in the same period as the corresponding lease costs. The Company incurred \$3.2 million, \$1.8 million and \$434,000 in cytopathology testing and evaluation services expenses with TCP in the years ended December 31, 2013, 2012 and 2011, respectively. The Company also reimbursed TCP for licensure fees of \$137,000 and \$83,000 in the years ended December 31, 2012 and 2011, respectively. Beginning in 2013, the Company is no longer obligated to reimburse TCP for licensure fees. Expenses for testing and evaluation services and reimbursed professional licensure fees are included in cost of revenue in the statements of operations and

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****7. Thyroid Cytopathology Partners (Continued)**

comprehensive loss. The Company's outstanding obligations to TCP for cytopathology testing services were \$588,000 and \$458,000 as of December 31, 2013 and 2012, respectively, and are included in accounts payable in the Company's balance sheets.

TCP's portion of rent and related operating expense costs for the shared space at the Austin, Texas facility was \$49,000 for the year ended December 31, 2013. The reduction to rent expense is included in the Company's cost of revenue in the statements of operations and comprehensive loss. TCP reimbursed the Company \$59,000 in 2013 and the resulting excess payment of \$10,000 is included in accounts payable in the Company's balance sheet at December 31, 2013.

**8. Commitments and Contingencies*****Operating Leases***

The Company leases its headquarters and South San Francisco laboratory facilities under a non-cancelable lease agreement that expired March 31, 2013. The lease was amended in July 2012 to extend the term to March 31, 2016 and to provide tenant improvement allowances of up to \$253,000. The Company provided security deposits in the form of irrevocable standby letters of credit secured with restricted cash deposits at the Company's primary bank. The Company deposited \$118,000 in restricted cash accounts as collateral for the lease which is included in restricted cash in the Company's balance sheets as of December 31, 2013 and 2012.

In November 2012, the Company entered into a non-cancelable lease agreement commencing February 1, 2013 to lease laboratory space in Austin, Texas. The lease expires on July 31, 2018. The Company paid a cash security deposit of \$75,000, which is included in other assets in the Company's balance sheet as of December 31, 2013 and 2012.

Future minimum lease payments under non-cancelable operating leases as of December 31, 2013 are as follows (in thousands):

<b>Year Ending December 31,</b>	<b>Amounts</b>
2014	\$ 938
2015	989
2016	413
2017	222
2018	130
Thereafter	
<b>Total minimum lease payments</b>	<b>\$ 2,692</b>

The Company recognizes rent expense on a straight-line basis over the non-cancelable lease period. Facilities rent expense was \$840,000, \$711,000 and \$570,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

***Volume Purchase Agreement***

The Company had non-cancelable purchase obligations to contract manufacturers and suppliers for approximately \$250,000 at December 31, 2013, of which \$125,000 and \$125,000 are estimated to be payable in the years ended December 31, 2014 and 2015, respectively.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****8. Commitments and Contingencies (Continued)***Contingencies*

From time to time, the Company may be involved in legal proceedings arising in the ordinary course of business. The Company believes there is no litigation pending that could have, individually or in the aggregate, a material adverse effect on the financial position, results of operations or cash flows.

**9. Debt**

In June 2013, the Company entered into a loan and security agreement with a financial institution to fund its working capital and other general corporate needs. The agreement provided for term loans of up to \$10.0 million in aggregate. The Company drew down \$5.0 million in funds under the agreement in June 2013. The carrying value of the debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. The debt is a level 3 liability, and as more fully discussed in Note 5 to the financial statements, level 3 inputs include unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the underlying asset or liability. The Company is required to repay the outstanding principal in 30 equal installments beginning 18 months after the date of the borrowing. The loan bears interest at a rate of 6.06% per annum. The loan carries prepayment penalties of 2.25% and 1.5% for prepayment within one and two years, respectively, of the loan origination and 0.75% thereafter. The Company may request a second term loan of up to \$5.0 million on or prior to March 31, 2014.

As more fully discussed in Note 10 of the financial statements, upon execution of the loan and security agreement, the Company issued the financial institution a warrant to purchase shares of Series C convertible preferred stock at \$7.56 per share. At the time of issuance, the aggregate fair value of the warrant for the 24,801 shares exercisable under the warrant was \$175,000. The fair value of the warrant was deducted from total proceeds, resulting in a debt discount to be amortized to interest expense over 48 months, through the maturity date of the initial loan, using the effective interest rate method, and was recorded as a preferred stock warrant liability. As more fully discussed in Note 10 to the Financial Statements, the warrant was converted to a warrant to purchase the Company's common stock upon the completion of the IPO. The end of term payment of \$223,000, representing 4.45% of the total outstanding principal balance, will be accreted over the life of the loan as interest expense. As a result of the debt discount and the end of term payment, the effective interest rate for the loan differs from the contractual rate. Total interest on the debt was \$233,000 for the year ended December 31, 2013, including \$75,000 in interest expense related to the amortization of the debt discount and accretion of the end of term payment, and \$158,000 of nominal interest.

The Company's obligations under the loan and security agreement are secured by a security interest in substantially all of its assets, excluding its intellectual property and certain other assets. The loan and security agreement contains customary conditions related to borrowing, events of default, and covenants, including covenants limiting the Company's ability to dispose of assets, undergo a change in control, merge with or acquire other entities, incur debt, incur liens, pay dividends or other distributions to holders of its capital stock, repurchase stock and make investments, in each case subject to certain exceptions. The agreement also allows the lender to call the debt in the event there is a material adverse change in the Company's business or financial condition. The loan and security agreement does not require that the Company comply with any financial covenants.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****10. Convertible Preferred Stock Warrants**

In June 2013, in conjunction with the execution of the loan and security agreement (Note 9), the Company issued to the lender a warrant to purchase up to 49,602 shares of Series C convertible preferred stock with an exercise price of \$7.56 per share. Upon the draw down of the \$5.0 million term loan, the warrant became exercisable for 24,801 shares. If the Company draws the second term loan, the remaining 24,801 shares will become exercisable under the warrant. The warrant expires at the earlier of (i) June 26, 2023 or (ii) the seventh anniversary of the Company's initial public offering. The warrant is exercisable in cash or through a cashless exercise provision. In connection with the IPO, as more fully described in Note 11, all of the Company's outstanding shares of convertible preferred stock were automatically converted into common stock and as a result, the warrant became exercisable for 24,801 shares of common stock (or 49,602 shares in the aggregate if the Company draws down the second term loan), at an exercise price of \$7.56 per share.

The fair value of the then currently exercisable portion of the warrant in the amount of \$175,000 was recorded as a preferred stock warrant liability upon issuance and is subject to remeasurement at each reporting period up to the closing date of the IPO when the Series C preferred stock converted into common stock. The fair value of the warrant upon issuance was calculated using the Black-Scholes option-pricing valuation model with the following assumptions: Series C preferred stock value of \$2.40 per share, contractual term of 7.3 years, risk-free interest rate of 2.1%, expected volatility of 73.7%, and expected dividend yield of 0%. Just prior to the closing of the IPO, the fair value of the warrant was approximately \$261,000, and was calculated using the Black-Scholes option-pricing valuation model with the following assumptions: Series C preferred stock value of \$13.14 per share, contractual term of 7.0 years, risk-free interest rate of 2.0%, expected volatility of 81.4%, and expected dividend yield of 0%. The change in the fair value of approximately \$86,000 was reported as an expense for the year ended December 31, 2013 and is included in other income (expense), net in the statements of operations. The warrant was converted into a warrant to purchase common stock upon the completion of the IPO in 2013, and was reclassified to additional paid-in-capital in the Company's balance sheet. As a result, the warrant is no longer subject to fair value remeasurement.

The warrant was exercised through a cashless exercise on March 17, 2014 resulting in the issuance of a net 13,739 shares of the Company's common stock.

**11. Convertible Preferred Stock**

On November 4, 2013, the Company completed its IPO. In connection with the IPO, the Company's 59,989,268 outstanding shares of convertible preferred stock were automatically converted into 14,997,312 shares of common stock.

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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**11. Convertible Preferred Stock (Continued)**

Convertible preferred stock as of December 31, 2012 consists of the following (in thousands, except for share data):

	Shares Authorized	Original Issue Price	Shares Issued and Outstanding	Aggregate Liquidation Amount	Proceeds Net of Issuance Costs and Preferred Stock Liability
Series A	22,399,999	\$ 1.00	22,399,999	22,400	22,328
Series B	22,748,000	1.25	22,748,000	28,435	26,968
Series C	14,000,000	1.89	7,936,508	15,000	14,076
Balance at December 31, 2012	59,147,999		53,084,507	\$ 65,835	\$ 63,372

In November 2012, the Company entered into a Series C Preferred Stock Purchase Agreement (the "Series C Agreement"). Under the Series C Agreement, the Company authorized the issuance and sale of an aggregate of 13,227,513 shares of its Series C convertible preferred stock, which may be sold in three closings: 7,910,053 shares in the initial purchase (the "Initial Closing"), 5,291,005 shares in the second closing ("the Second Closing"), and 26,455 shares in an additional closing (the "First Additional Closing").

The Initial Closing of the Series C convertible preferred stock occurred in November 2012 and the First Additional Closing in December 2012. In the Initial Closing and the First Additional Closing, the Company issued an aggregate of 7,936,508 shares of its Series C convertible preferred stock at a price per share of \$1.89 for gross proceeds of \$15.0 million.

In June 2013, the Company amended its Amended and Restated Certificate of Incorporation to increase the number of authorized shares of Series C convertible preferred stock from 14,000,000 to 14,852,001 and amended the Series C Agreement to increase the number of shares that could be sold in additional closings from 26,455 to a total of 1,640,212. The Company completed the Second Closing and two additional closings under the Series C Agreement and received gross proceeds of \$13.0 million for the issuance of 6,904,761 shares.

***Preferred Stock Liability***

In November 2012, the Company recorded a preferred stock liability as the investors received the right to purchase from the Company, on the same terms, additional shares of Series C convertible preferred stock, in a second tranche. As the investors hold a majority of the board seats, the decision to complete the second tranche was deemed to be outside the control of the Company. The preferred stock liability was valued using the option-pricing method with the following assumptions: 100% probability of success of the second tranche, fair value of Series C preferred stock of \$1.78, a term of 0.67 years and expected volatility of 44%. This resulted in an initial fair value of \$0.9 million for the Company's obligation to sell the convertible preferred stock. At December 31, 2012, the Company revalued the preferred stock liability to \$0.6 million, and recorded the \$0.3 million valuation decrease to other income (expense), net in the Company's statements of operations and comprehensive loss. In June 2013, the Company revalued the preferred stock liability to \$2.7 million and recorded the \$2.1 million valuation increase to other income (expense), net in the Company's statements of operations and comprehensive loss. In June 2013, the \$2.7 million liability was settled upon the issuance of the second tranche of Series C convertible preferred stock and was reclassified to additional paid-in-capital in the Company's balance sheets.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****12. Stockholders' Equity (Deficit)*****Common Stock***

The Company's Restated Certificate of Incorporation authorizes the Company to issue 125,000,000 shares of common stock with a par value of \$0.001 per share. The holder of each share of common stock shall have one vote for each share of stock. The common stockholders are also entitled to receive dividends whenever funds and assets are legally available and when declared by the Board of Directors, subject to the prior rights of holders of all series of convertible preferred stock outstanding. No dividends have been declared as of December 31, 2013.

As of December 31, 2013 and 2012, the Company had reserved shares of common stock for issuance as follows:

	<b>As of December 31,</b>	
	<b>2013</b>	<b>2012</b>
Conversion of Series A convertible preferred stock		5,599,999
Conversion of Series B convertible preferred stock		5,686,999
Conversion of Series C convertible preferred stock		1,984,124
Conversion of Series C convertible preferred stock reserved for issuance		1,322,751
Options issued and outstanding	2,359,287	2,227,669
Options available for grant under stock option plans	1,787,802	347,386
Common stock warrants issued and outstanding	24,801	
Total	4,171,890	17,168,928

***Preferred Stock***

The Company's Restated Certificate of Incorporation, which became effective on November 4, 2013, authorizes the Company to issue 5,000,000 shares of preferred stock with a par value of \$0.001 per share. No shares were issued and outstanding at December 31, 2013.

**13. Stock Incentive Plans*****Stock Option Plans***

On February 15, 2008, the Company adopted the 2008 Stock Plan (the "2008 Plan"). The 2008 Plan provides for the granting of options to purchase common stock and common stock to employees, directors and consultants of the Company. The Company may grant incentive stock options ("ISOs"), non-statutory stock options ("NSOs") or restricted stock under the 2008 Plan. ISOs may only be granted to Company employees (including directors who are also considered employees). NSOs and restricted stock may be granted to Company employees, directors and consultants. Options may be granted for terms of up to ten years from the date of grant, as determined by the Board of Directors, provided however, that with respect to an ISO granted to a person who owns stock representing more than 10% of the voting power of all classes of stock of the Company, the term shall be for no more than five years from the date of grant. The exercise price of options granted must be at a price no less than 100% of the estimated fair value of the shares on the date of grant, as determined by the Board of Directors, provided however, that with respect to an ISO granted to an employee who at the time of grant of such option owns stock representing more than 10% of the voting power of all classes of stock of the Company, the exercise price shall not be less than 110% of the estimated fair value of the shares on the date of grant. Options granted to newly hired

**VERACYTE, INC.**

**Notes to Audited Financial Statements (Continued)**

**13. Stock Incentive Plans (Continued)**

employees generally vest over four years (generally 25% after one year and monthly thereafter). Options granted to employees as part of annual bonus compensation are generally fully vested at the grant date.

On October 2, 2013, the Company adopted the 2013 Stock Incentive Plan (the "2013 Plan"). The 2013 Plan was subsequently approved by the Company's stockholders and became effective on November 4, 2013, immediately before the closing of the IPO. Following the effectiveness of the 2013 Plan, no additional options will be granted under the 2008 Plan. An aggregate of 1,700,000 additional shares are reserved for issuance under the 2013 Plan. In addition, to the extent that any awards outstanding or subject to vesting restrictions under the 2008 Plan are subsequently forfeited or terminated for any reason before being exercised or settled, the shares of common stock reserved for issuance pursuant to such awards as of the closing of the IPO will become available for issuance under the 2013 Plan. The remaining shares available for grant under the 2008 Plan became available for issuance under the 2013 Plan upon the closing of the IPO. On the first day of each year from 2014 to 2023, the 2013 Plan authorizes an annual increase of the lesser of 4% of outstanding shares on the last day of the immediately preceding fiscal year or a lesser amount as determined by the Company's Board of Directors. As of December 31, 2013, 1,787,802 shares were available for future issuance under the 2013 Plan.

Pursuant to the 2013 Plan, stock options, restricted shares, stock units, including restricted stock units and stock appreciation rights may be granted to employees, consultants, and outside directors of the Company. Options granted may be either ISOs or NSOs.

Stock options are governed by stock option agreements between the Company and recipients of stock options. ISOs and NSOs may be granted under the 2013 Plan at an exercise price of not less than 100% of the fair market value of the common stock on the date of grant, determined by the Compensation Committee of the Board of Directors. Options become exercisable and expire as determined by the Compensation Committee, provided that the term of ISOs may not exceed ten years from the date of grant. Stock option agreements may provide for accelerated exercisability in the event of an optionee's death, disability, or retirement or other events.

Any outside director who was not previously an employee and who first joins the Company's Board of Directors on or after the effective date of the 2013 Plan will be automatically granted an initial NSO to purchase 35,000 shares of common stock upon first becoming a member of the Board of Directors. Twenty-five percent of the shares subject to the initial option will vest and become exercisable on the first anniversary of the date of grant. The balance (*i.e.* remaining 75%) will vest and become exercisable over three years in equal monthly installments. On the first business day after each regularly scheduled annual meeting of stockholders, each outside director who was not elected to the Board of Directors for the first time at such meeting and who will continue serving as a member of the Board of Directors thereafter will be automatically granted an option to purchase 10,000 shares of common stock, provided that the outside director has served on the Board of Directors for at least six months. Each annual option will vest and become exercisable on the first anniversary of the date of grant, or immediately prior to the next regular annual meeting of the Company's stockholders following the date of grant if the meeting occurs prior to the first anniversary date. The options granted to outside directors will have a per share exercise price equal to 100% of the fair market value of the underlying shares on the date of grant and will become fully vested in the event of a change of control. In addition, such options will terminate on the earlier of (i) the day before the 10th anniversary of the date of grant or (ii) the date 12 months after the termination of the outside director's termination of service for any reason.



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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

## 13. Stock Incentive Plans (Continued)

Activity under the Company's stock option plans is set forth below (intrinsic value in thousands):

	Shares Available for Grant	Stock Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Balance December 31, 2011	474,961	1,429,737	\$ 1.55	8.22	\$ 1,221
Additional options authorized	743,100				
Granted	(931,944)	931,944	2.78		
Canceled	61,269	(61,269)	1.97		
Exercised		(72,743)	1.05		
Balance December 31, 2012	347,386	2,227,669	\$ 2.06	8.17	\$ 4,311
Additional options authorized	1,950,000				
Granted	(695,029)	695,029	5.32		
Canceled	185,445	(185,445)	2.69		
Exercised		(377,966)	1.46		
Balance December 31, 2013	1,787,802	2,359,287	\$ 3.07	7.84	\$ 26,964
Options exercisable December 31, 2013		1,273,335	\$ 2.10	7.12	\$ 15,788
Options vested and expected to vest December 31, 2013		2,250,293	\$ 3.02	7.80	\$ 25,842

Outstanding and exercisable stock options as of December 31, 2013 are summarized as follows (intrinsic value in thousands):

Exercise Prices	Options Outstanding			Options Vested and Exercisable		
	Number of Options Outstanding	Weighted Average Remaining	Aggregate Intrinsic Value	Number of Options Exercisable	Weighted Average Remaining	Aggregate Intrinsic Value

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	Contractual Life (Years)			Contractual Life (Years)		
\$0.08	177,750	4.64	\$ 2,563	177,750	4.64	\$ 2,563
\$0.80	165,569	6.14	2,268	158,458	6.13	2,171
\$2.36	414,874	6.81	5,037	340,023	6.81	4,128
\$2.40	208,593	7.68	2,524	147,299	7.69	1,782
\$2.68	653,952	8.28	7,730	319,005	8.26	3,771
\$4.00	473,299	9.08	4,970	130,800	9.06	1,373
\$6.04	197,875	9.47	1,674			
\$7.92	9,000	9.69	59			
\$12.12	58,375	9.75	139			
\$0.08 - \$12.12	2,359,287	7.84	\$ 26,964	1,273,335	7.12	\$ 15,788

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying stock options and the fair value of the Company's common stock for stock options that were in-the-money.

**VERACYTE, INC.**

**Notes to Audited Financial Statements (Continued)**

**13. Stock Incentive Plans (Continued)**

The weighted average fair value of options to purchase common stock granted was \$4.19 and \$1.95 in the years ended December 31, 2013 and 2012, respectively.

The weighted average fair value of options to purchase common stock vested was \$2.12 and \$1.40 per share in the years ended December 31, 2013 and 2012. The total estimated grant date fair value of employee options to purchase common stock vested during the years ended December 31, 2013 and 2012 was \$1.3 million and \$0.6 million, respectively.

The weighted average fair value of options to purchase common stock exercised was \$0.97 and \$0.88 in the years ended December 31, 2013 and 2012, respectively. The intrinsic value of options to purchase common stock exercised was \$4.9 million and \$0.2 million in the years ended December 31, 2013 and 2012, respectively. The fair market value of the Company's common stock as of December 31, 2013 and 2012 was \$14.50 and \$4.00 per share, respectively.

***Stock-based Compensation***

The Company uses the grant date fair market value of its common stock to value both employee and non-employee options when granted. The Company revalues non-employee options each reporting period using the fair market value of the Company's common stock as of the last day of each reporting period.

***Determining Fair Value of Stock Options***

The fair value of the underlying common stock was determined by the Board of Directors until the IPO, when the Company's common stock started trading on The NASDAQ Global Select Market. Because there was no public market for the Company's common stock, the Board of Directors determined fair value of the common stock at the time of grant of the option by considering a number of objective and subjective factors including important developments in the Company's operations, valuations performed by an independent third party, sales of convertible preferred stock, actual operating results and financial performance, the conditions in our industry and the economy in general, the stock price performance of comparable public companies, and the lack of liquidity of the Company's common stock, among other factors.

The Black-Scholes option-pricing valuation model is used to determine the fair value of stock options. The input assumptions used to estimate fair value of these awards include the exercise price of the award, the expected option term, the expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected dividend yield, if any.

The estimated expected term of options granted is determined by taking the average of the vesting term and the contractual term of each option. As the Company has limited stock price history from which to forecast stock price volatility, it estimates common stock price volatility by calculating the actual average volatility of the common stock of a selected peer group whose share price is publicly available. The Company uses a look-back period commensurate with the expected life of each option award. The risk-free interest rates used in the valuation model are based on U.S. Treasury issues with remaining terms similar to the expected term of the options. The Company does not anticipate paying any dividends in the foreseeable future and therefore used an expected dividend yield of zero.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****13. Stock Incentive Plans (Continued)***Summary of Assumptions*

The fair value of share-based payments for option granted to employees and directors was estimated on the date of grant using the Black-Scholes option-pricing valuation model based on the following weighted average assumptions:

	Year Ended December 31,	
	2013	2012
Expected term (in years)	5.00 - 6.08	5.00 - 6.08
Expected volatility	80.42 - 81.41%	82.07 - 84.33%
Risk-free interest rate	0.88 - 2.11%	0.65 - 1.19%

## Dividend yield

Stock-based compensation related to stock options granted to non-employees is recognized as the stock options are earned, generally through the provision of services. The Company believes the fair value of the stock-based awards is more reliably measureable than the fair value of services received. The fair value of the stock options granted is calculated at each reporting date using the Black-Scholes option-pricing model with the following assumptions: expected life is equal to the remaining contractual term of the award as of the measurement date ranging from 7.72 years to 9.75 years as of December 31, 2013 and 8.23 years to 9.93 years as of December 31, 2012; risk free rate is 2.59% to 2.99% for the year ended December 31, 2013 and 1.43% to 1.77% for the year ended December 31, 2012; expected dividend yield of 0%; and volatility ranging from 77.86% to 78.14% as of December 31, 2013 and 81.14% to 82.11% as of December 31, 2012.

The following table summarizes stock-based compensation expense related to stock options for the years ended December 31, 2013, 2012 and 2011, included in the statements of operations and comprehensive loss as follows (in thousands):

	Year Ended December 31,		
	2013	2012	2011
Cost of revenue	\$ 34	\$ 26	\$ 32
Research and development	250	131	130
Selling and marketing	169	111	77
General and administrative	794	407	227
<b>Total stock-based compensation expense</b>	<b>\$ 1,247</b>	<b>\$ 675</b>	<b>\$ 466</b>

If all of the remaining non-vested and outstanding stock option awards that have been granted vested, the Company would recognize approximately \$2.7 million in compensation expense over a weighted average remaining period of 2.9 years. No compensation expense will be recognized for any stock options that do not vest.

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****13. Stock Incentive Plans (Continued)*****Equity-based Compensation***

For the year ended December 31, 2013, the Company will pay executive bonuses only in the form of cash.

For the years ended December 31, 2012 and 2011, the Company paid a portion of its executive bonuses through the grant of stock options. The equity transaction associated with these bonuses is classified as equity-based compensation expense. Accruals for the anticipated grants were \$259,000 and \$193,000 in the years ended December 31, 2012 and 2011, respectively, and are included in accrued liabilities in the balance sheets. The expenses were determined as follows:

In March 2012, the Company's Board of Directors authorized the grant of 109,653 fully vested stock options at a fair value of \$1.76 resulting in \$193,000 in expense in the year ended December 31, 2011. The fair value of the options was determined using the Black-Scholes option-pricing valuation model with the following assumptions: the option exercise strike price was \$2.68 equal to the fair market value of the Company's common stock at grant date, risk free rate of 0.88%, expected term of 5.0 years, volatility rate of 83.52% and expected dividend yield of 0%. Upon issuance of the fully vested options, the liability was reclassified into additional paid-in capital.

In February 2013, the Company's Board of Directors authorized the grant of 100,498 fully vested stock options at a fair value of \$2.59 resulting in \$259,000 in expense in the year ended December 31, 2012. The fair value of the options was determined using the Black-Scholes option-pricing valuation model with the following assumptions: the option exercise strike price was \$4.00 equal to the fair market value of the Company's common stock at grant date, risk-free rate of 0.88%, expected term of 5.0 years, volatility rate of 81.41% and expected dividend yield of 0%. Upon issuance of the fully vested options, the liability was reclassified into additional paid-in capital.

The following table summarizes equity-based compensation expense for the years ended December 31, 2013, 2012 and 2011, which were included in the statements of operations and comprehensive loss as follows (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Cost of revenue	\$	\$ 2	\$ 2
Research and development		100	80
Selling and marketing		39	41
General and administrative		118	70
<b>Total equity-based compensation expense</b>	<b>\$</b>	<b>\$ 259</b>	<b>\$ 193</b>

**14. Income Taxes**

The Company generated a pretax loss of \$25.6 million, \$18.6 million and \$14.4 million in the United States for the years ended December 31, 2013, 2012 and 2011, respectively. Since inception, the Company has not generated any pretax income or loss outside of the United States. The Company did not record a provision or benefit for income taxes during the years ended December 31, 2013, 2012 and 2011. The



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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**14. Income Taxes (Continued)**

Company follows FASB ASC No. 740, *Income Taxes for the Computation and Presentation of its Tax Provision*. The following table presents a reconciliation of the tax expense computed at the statutory federal rate and the Company's tax expense for the period presented (in thousands):

	Year Ended December, 31,		
	2013	2012	2011
U.S. federal taxes at statutory rate	\$ (8,697)	\$ (6,341)	\$ (4,911)
State taxes (net of federal benefit)	11	(1,074)	(843)
Permanent differences	1,145	261	(108)
Tax credits	(502)	(113)	(181)
Change in valuation allowance	8,043	7,267	6,043
Total	\$	\$	\$

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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**14. Income Taxes (Continued)**

The tax effects of temporary differences and carryforwards that give rise to significant portions of the deferred tax assets are as follows (in thousands):

	As of December 31,		
	2013	2012	2011
Current deferred tax assets:			
Net operating loss carryforwards	\$	\$	\$
Research and development credit			
Stock-based compensation			
Genzyme co-promotion agreement	1,005	1,001	
Accruals and deferred rent	599	148	
<b>Gross deferred tax assets</b>	<b>1,604</b>	<b>1,149</b>	
Valuation allowance	(1,603)	(1,145)	
<b>Net deferred tax assets</b>	<b>1</b>	<b>4</b>	
Deferred tax liabilities:			
Property and equipment			
Gross deferred tax liabilities			
<b>Net current deferred tax liabilities</b>	<b>1</b>	<b>4</b>	
Non-current deferred tax assets:			
Net operating loss carryforwards	28,569	20,536	16,547
Research and development credit	1,455	954	723
Stock-based compensation	313	154	50
Genzyme co-promotion agreement	787	2,048	
Accruals, depreciation and deferred rent	106	9	197
<b>Gross deferred tax assets</b>	<b>31,230</b>	<b>23,701</b>	<b>17,517</b>
Valuation allowance	(31,216)	(23,622)	(17,469)
<b>Net deferred tax assets</b>	<b>14</b>	<b>79</b>	<b>48</b>
Deferred tax liabilities:			
Property and equipment	(15)	(83)	(48)



Gross deferred tax liabilities	(15)	(83)	(48)
Net non-current deferred tax liabilities	(1)	(4)	
Total deferred tax assets	\$	\$	\$

The Company has established a full valuation allowance against its deferred tax assets due to the uncertainty surrounding realization of such assets. The valuation allowance increased \$8.1 million and \$7.3 million during the years ended December 31, 2013 and 2012, respectively.

The Company had \$0.3 million of cumulative excess tax benefits from stock option deductions generated subsequent to the adoption of the authoritative guidance regarding stock-based compensation, which are not included in the net operating loss carryforward amounts above since they have not met the required realization criteria. The Company considers stock option deduction benefits in excess of book

Table of Contents**VERACYTE, INC.****Notes to Audited Financial Statements (Continued)****14. Income Taxes (Continued)**

compensation charges realized when it obtains an incremental benefit determined by the "with and without" calculation method, under which excess tax benefits related to stock-based compensation are not deemed to be realized until after the utilization of all other tax benefits available to the Company. When realized, these benefits will increase additional paid-in capital.

As of December 31, 2013, the Company had net operating loss carryforwards of approximately \$75.1 million and \$54.0 million available to reduce future taxable income, if any, for Federal and state income tax purposes, respectively. The U.S. federal net operating loss carryforwards will begin to expire in 2026 while for state purposes, the net operating losses will begin to expire in 2018.

As of December 31, 2013, the Company had credit carryforwards of approximately \$1.4 million and \$1.0 million available to reduce future taxable income, if any, for Federal and California state income tax purposes, respectively. The Federal credit carryforwards begin to expire in 2028. California credits have no expiration date.

The Internal Revenue Code of 1986, as amended, imposes restrictions on the utilization of net operating losses and tax credits in the event of an "ownership change" of a corporation. Accordingly, a company's ability to use net operating losses and tax credits may be limited as prescribed under Internal Revenue Code Section 382 and 383 ("IRC Section 382"). Events which may cause limitations in the amount of the net operating losses or tax credits that the Company may use in any one year include, but are not limited to, a cumulative ownership change of more than 50% over a three-year period. Utilization of the federal and state net operating losses may be subject to substantial annual limitation due to the ownership change limitations provided by the IRC Section 382 rules and similar state provisions. In the event the Company has any changes in ownership, net operating losses and research and development credit carryovers could be limited and may expire unutilized.

As of December 31, 2013, the Company had unrecognized tax benefits of \$0.7 million, all of which would not currently affect the Company's effective tax rate if recognized due to the Company's deferred tax assets being fully offset by a valuation allowance. The Company does not anticipate that the amount of unrecognized tax benefits relating to tax positions existing at December 31, 2013 will significantly increase or decrease within the next twelve months.

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

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Unrecognized tax benefits, beginning of period	\$ 481	\$ 341	\$ 263
Gross increases tax position in prior period	68	67	
Gross decrease tax position in prior period			
Gross increases current period tax positions	178	73	78
Lapse of statute of limitations			
Unrecognized tax benefits, end of period	\$ 728	\$ 481	\$ 341

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## VERACYTE, INC.

## Notes to Audited Financial Statements (Continued)

**14. Income Taxes (Continued)**

It is the Company's policy to include penalties and interest expense related to income taxes as a component of other expense and interest expense, respectively, as necessary. There was no interest expense or penalties related to unrecognized tax benefits recorded through December 31, 2013.

The Company's major tax jurisdictions are the United States and California. All of the Company's tax years will remain open for examination by the Federal and state tax authorities for three and four years, respectively, from the date of utilization of the net operating loss or research and development credit. The Company does not have any tax audits pending.

**15. 401(k) Plan**

The Company sponsors a 401(k) defined contribution plan covering all employees. There were no employer contributions to the plan in the years ended December 31, 2013 and 2012.

**16. Selected Quarterly Financial Data (Unaudited)**

The following table presents selected unaudited consolidated financial data for each of the eight quarters in the two-year period ended December 31, 2013. The Company believes this information reflects all recurring adjustments necessary to fairly present this information when read in conjunction with the Company's financial statements and the related notes. Net loss per share-basic and diluted, for the four quarters of each fiscal year may not sum to the total for the fiscal year because of the different number of shares outstanding during each period. The results of operations for any quarter are not necessarily indicative of the results to be expected for any future period.

Quarter Ended:	March 31	June 30	September 30	December 31
	(In thousands, except share and per share data)			
<b>2013:</b>				
Total revenues	\$ 4,384	\$ 5,068	\$ 5,594	\$ 6,838
Net loss	\$ (6,895)	\$ (6,490)	\$ (6,303)	\$ (5,892)
Net loss per common share, basic and diluted	\$ (9.04)	\$ (7.53)	\$ (6.59)	\$ (0.42)
Shares used in calculation of net loss per share, basic and diluted	763,021	861,839	955,890	13,944,239
<b>2012:</b>				
Total revenues	\$ 1,468	\$ 2,479	\$ 3,224	\$ 4,457
Net loss	\$ (4,248)	\$ (4,626)	\$ (4,938)	\$ (4,837)
Net loss per common share, basic and diluted	\$ (6.81)	\$ (7.08)	\$ (7.49)	\$ (7.27)
Shares used in calculation of net loss per share, basic and diluted	623,515	653,121	659,129	665,306

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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We maintain "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Annual Report on Form 10-K, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of our registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies.

**ITEM 9B. OTHER INFORMATION**

None.

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**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this item with respect to directors is incorporated by reference from the information under the caption "Election of Directors" contained in our Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for our 2014 Annual Meeting of Stockholders to be held on May 19, 2014, or Proxy Statement. Certain information required by this item concerning executive officers is set forth in Part I of this Report under the caption "Executive Officers of the Registrant" and is incorporated herein by reference.

Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16(a) of the Exchange Act. This disclosure is contained in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

We have adopted a Code of Business Conduct and Ethics that applies to all of our officers and employees, including our President and Chief Executive Officer, our Chief Financial Officer and other employees who perform financial or accounting functions. The Code of Business Conduct and Ethics sets forth the basic principles that guide the business conduct of our employees. We have also adopted a Senior Financial Officers' Code of Ethics that specifically applies to our President and Chief Executive Officer, our Chief Financial Officer, and key management employees. Stockholders may request a free copy of our Code of Business Conduct and Ethics and our Senior Financial Officers' Code of Ethics by contacting Veracyte, Inc., Attention: Chief Financial Officer, 7000 Shoreline Court, Suite 250, South San Francisco, California 94080.

To date, there have been no waivers under our Code of Business Conduct and Ethics or Senior Financial Officers' Code of Ethics. We intend to disclose future amendments to certain provisions of our Code of Business Conduct and Ethics or Senior Financial Officers' Code of Ethics or waivers of such Codes granted to executive officers and directors on our website at <http://www.veracyte.com> within four business days following the date of such amendment or waiver.

Our Board of Directors has appointed an Audit Committee, comprised of Ms. Karin Eastham, as Chairwoman, Brian G. Atwood and Dr. Fred E. Cohen. The Board of Directors has determined that Ms. Eastham qualifies as an Audit Committee Financial Expert under the definition outlined by the Securities and Exchange Commission. In addition, each of the members of the Audit Committee qualifies as an "independent director" under the current rules of The NASDAQ Stock Market and Securities and Exchange Commission rules and regulations.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item is incorporated by reference from the information under the captions "Election of Directors Director Compensation" and "Executive Compensation" contained in the Proxy Statement.

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

The information required by this item is incorporated by reference from the information under the captions "Security Ownership of Certain Beneficial Owners and Management" and "Executive Compensation Equity Compensation Plan Information" contained in the Proxy Statement.

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

The information required by this item is incorporated by reference from the information under the caption "Election of Directors Certain Relationships and Related Transactions" and " Director Independence" contained in the Proxy Statement.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this item is incorporated by reference from the information under the caption "Ratification of the Appointment of Independent Registered Public Accounting Firm Principal Accountant Fees and Services" contained in the Proxy Statement.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) Documents filed as part of this report

1. Financial Statements:

Reference is made to the Index to Financial Statements of Veracyte, Inc. included in Item 8 of Part II hereof.

2. Financial Statement Schedules

All schedules have been omitted because they are not required, not applicable, or the required information is included in the financial statements or notes thereto.

3. Exhibits

See Item 15(b) below. Each management contract or compensating plan or arrangement required to be filed has been identified.

(b) Exhibits

<b>Exhibit Number</b>	<b>Description</b>
3.1	Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed November 8, 2013).
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant's Current Report on Form 8-K filed November 8, 2013).
4.1	Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
4.2	Second Amended and Restated Investors Rights Agreement, dated November 6, 2012, between the Registrant and certain investors (incorporated by reference to Exhibit 4.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
4.3	Amendment to Second Amended and Restated Investors Rights Agreement, dated June 14, 2013, between the Registrant and certain investors (incorporated by reference to Exhibit 4.3 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
4.4	Warrant to Purchase Series C Preferred Stock dated June 26, 2013 (incorporated by reference to Exhibit 4.4 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.1#	Form of Indemnification Agreement between the Registrant and its officers and directors (incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282) , as amended, declared effective on October 29, 2013).
10.2#	2008 Stock Plan and forms of agreements thereunder (incorporated by reference to Exhibit 10.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).

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<b>Exhibit Number</b>	<b>Description</b>
10.3#	2013 Stock Incentive Plan and forms of agreements thereunder (incorporated by reference to Exhibit 10.3 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.4	Lease Agreement dated as of February 10, 2010 between ARE-San Francisco No 17, LLC and the Registrant (incorporated by reference to Exhibit 10.4 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.5	First Amendment to Lease Agreement entered into as of July 11, 2012 between ARE-San Francisco No 17, LLC and the Registrant (incorporated by reference to Exhibit 10.5 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.6	Lease Agreement between Riata Holdings, L.P., as landlord, and the Registrant, as tenant, dated November 28, 2012 (incorporated by reference to Exhibit 10.6 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.7*	First Amendment to Lease Agreement dated as of January 7, 2014 by and between Riata Holdings, L.P. and the Registrant.
10.8	Co-promotion Agreement dated as of January 18, 2012 between Genzyme Corporation and the Registrant (incorporated by reference to Exhibit 10.7 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.9	Amendment to Co-promotion Agreement, effective April 9, 2013, between Genzyme Corporation and the Registrant (incorporated by reference to Exhibit 10.8 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.10	Loan and Security Agreement dated as of June 26, 2013 between Silicon Valley Bank and the Registrant (incorporated by reference to Exhibit 10.9 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.11#	Employment Agreement, dated as of February 15, 2008, between Bonnie Anderson and the Registrant (incorporated by reference to Exhibit 10.10 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.12#	Amendment to Bonnie Anderson Employment Agreement, dated as of December 22, 2008, between Bonnie Anderson and the Registrant (incorporated by reference to Exhibit 10.11 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.13#	Amendment No. 2 to Bonnie Anderson Employment Agreement, effective as of March 11, 2009, between Bonnie Anderson and the Registrant (incorporated by reference to Exhibit 10.12 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).



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<b>Exhibit Number</b>	<b>Description</b>
10.14#	Change of Control and Severance Agreement, effective as of August 24, 2012, between Bonnie Anderson and the Registrant (incorporated by reference to Exhibit 10.13 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.15#	Change of Control and Severance Agreement, effective as of August 24, 2012, between Christopher Hall and the Registrant (incorporated by reference to Exhibit 10.14 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.16#	Change of Control and Severance Agreement, effective as of April 8, 2013, between Shelly Guyer and the Registrant (incorporated by reference to Exhibit 10.15 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.17#	Executive Bonus Plan (incorporated by reference to Exhibit 10.16 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.18#	Offer Letter dated as of April 8, 2013 with Shelly D. Guyer (incorporated by reference to Exhibit 10.17 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.19#	Offer Letter dated as of January 28, 2010 with Christopher M. Hall (incorporated by reference to Exhibit 10.18 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.20	Pathology Services Agreement dated as of November 12, 2010 between Brazos Valley Pathology, P.A. D/B/A Reitpath and the Registrant (incorporated by reference to Exhibit 10.19 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.21	Approval of the Registrant to the Assignment of the Pathology Services Agreement with Brazos Valley Pathology to Thyroid Cytopathology Partners, P.A. as of May 18, 2011 (incorporated by reference to Exhibit 10.20 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.22	First Amendment to Pathology Services Agreement dated as of December 19, 2012 between Thyroid Cytopathology Partners, P.A. and the Registrant (incorporated by reference to Exhibit 10.21 to the Registrant's Registration Statement on Form S-1 (File No. 333-191282), as amended, declared effective on October 29, 2013).
10.23*	Second Amendment to Pathology Services Agreement dated as of January 1, 2014 by and between the Registrant and Thyroid Cytopathology Partners, P.A.
23.1*	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm.
24.1*	Power of Attorney (see page 117 of this Annual Report on Form 10-K).
31.1*	Principal Executive Officer's Certifications Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Principal Financial Officer's Certifications Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification Pursuant to 18 U.S.C. § 1350 (Section 906 of Sarbanes-Oxley Act of 2002).

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<b>Exhibit Number</b>	<b>Description</b>
32.2**	Certification Pursuant to 18 U.S.C. § 1350 (Section 906 of Sarbanes-Oxley Act of 2002).
101.INS##	XBRL Instance Document
101.SCH##	XBRL Taxonomy Extension Schema
101.CAL##	XBRL Taxonomy Extension Calculation Linkbase
101.DEF##	XBRL Taxonomy Extension Definition Linkbase
101.LAB##	XBRL Taxonomy Extension Label Linkbase
101.PRE##	XBRL Taxonomy Extension Presentation Linkbase

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Confidential treatment has been granted with respect to certain portions of this Exhibit.

#Indicates management contract or compensatory plan or arrangement.

\*

Filed herewith.

\*\*

In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-K and will not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934 (the "Exchange Act") or deemed to be incorporated by reference into any filing under the Exchange Act or the Securities Act of 1933 (the "Securities Act") except to the extent that the registrant specifically incorporates it by reference.

##

In accordance with Rule 406T of Regulation S-T, the information furnished in these exhibits will not be deemed "filed" for purposes of Section 18 of the Exchange Act. Such exhibits will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act except to the extent that the registrant specifically incorporates it by reference.

Copies of the above exhibits not contained herein are available to any stockholder, upon payment of a reasonable per page fee, upon written request to: Chief Financial Officer, Veracyte, Inc., 7000 Shoreline Court, Suite 250, South San Francisco, California 94080.

(c)

Financial Statement Schedules

Reference is made to Item 15(a) 2 above.



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<b>Signature</b>	<b>Title</b>	<b>Date</b>
<hr/> <i>/s/ SAMUEL D. COLELLA</i> Samuel D. Colella	Director	March 20, 2014
<hr/> <i>/s/ KARIN EASTHAM</i> Karin Eastham	Director	March 20, 2014
<hr/> <i>/s/ EVAN JONES</i> Evan Jones	Director	March 20, 2014
<hr/> <i>/s/ JESSE I. TREU, PH.D.</i> Jesse I. Treu, Ph.D.	Director	March 20, 2014