

THORATEC CORP
Form 10-Q
August 10, 2010

Table of Contents

**U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 July 3, 2010**

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: 000-49798

THORATEC CORPORATION

(Exact name of registrant as specified in its charter)

California

**(State or other jurisdiction of incorporation
or organization)**

94-2340464

(I.R.S. Employer Identification No.)

**6035 Stoneridge Drive, Pleasanton, California
(Address of principal executive offices)**

94588

(Zip Code)

(925) 847-8600

(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 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 Smaller reporting company

(Do not check if a 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

As of July 31, 2010, the registrant had 58,460,160 shares of common stock outstanding.

**THORATEC CORPORATION
TABLE OF CONTENTS**

| | |
|---|----|
| <u>Part I. Financial Information</u> | |
| <u>Item 1. Unaudited Condensed Consolidated Financial Statements</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of July 3, 2010 and January 2, 2010</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three and Six Months Ended July 3, 2010 and July 4, 2009</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended July 3, 2010 and July 4, 2009</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 25 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 37 |
| <u>Item 4. Controls and Procedures</u> | 38 |
| <u>Part II. Other Information</u> | |
| <u>Item 1A. Risk Factors</u> | 40 |
| <u>Item 2. Unregistered Sale of Equity Securities and Use of Proceeds</u> | 40 |
| <u>Item 6. Exhibits</u> | 41 |
| <u>Signatures</u> | 42 |
| Exhibits | |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |
| <u>EX-32.2</u> | |
| <u>EX-101 INSTANCE DOCUMENT</u> | |
| <u>EX-101 SCHEMA DOCUMENT</u> | |
| <u>EX-101 CALCULATION LINKBASE DOCUMENT</u> | |
| <u>EX-101 LABELS LINKBASE DOCUMENT</u> | |
| <u>EX-101 PRESENTATION LINKBASE DOCUMENT</u> | |

Thoratec, the Thoratec logo, Thoralon, HeartMate, and HeartMate II are registered trademarks of Thoratec Corporation, and IVAD is a trademark of Thoratec Corporation.

CentriMag is a registered trademark of Levitronix LLC.

ITC, A-VOX Systems, AVOXimeter, HEMOCHRON, ProTime, ProTime In Rhythm, Surgicutt, Tenderlett, Tenderfoot, and IRMA are registered trademarks of International Technidyne Corporation (ITC), Thoratec Corporation's wholly-owned subsidiary.

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****THORATEC CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)
(in thousands)**

| | July 3, 2010 | January 2, 2010 |
|--|---------------------|----------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 37,435 | \$ 27,787 |
| Short-term available-for-sale investments | 314,724 | 279,174 |
| Receivables, net of allowances of \$1,086 and \$322, respectively | 50,798 | 48,058 |
| Inventories | 48,505 | 44,635 |
| Deferred tax assets | 12,564 | 12,261 |
| Prepaid expenses and other assets | 4,611 | 4,831 |
| Prepaid income taxes | 20,188 | 1,234 |
| Assets held for sale | 60,848 | 63,798 |
| Total current assets | 549,673 | 481,778 |
| Property, plant and equipment, net | 37,106 | 37,115 |
| Goodwill | 95,015 | 95,015 |
| Purchased intangible assets, net | 93,409 | 96,876 |
| Long-term available-for-sale investments | 24,166 | 24,634 |
| Other long-term assets | 9,935 | 12,465 |
| Total Assets | \$ 809,304 | \$ 747,883 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 16,187 | \$ 6,221 |
| Accrued compensation | 12,692 | 17,417 |
| Other accrued liabilities | 10,499 | 12,469 |
| Senior subordinated convertible notes | 133,882 | |
| Liabilities related to assets held for sale | 12,084 | 12,377 |
| Total current liabilities | 185,344 | 48,484 |
| Senior subordinated convertible notes | | 131,929 |
| Long-term deferred tax liability | 28,192 | 31,720 |
| Other | 9,996 | 10,622 |
| Total Liabilities | 223,532 | 222,755 |
| Shareholders equity: | | |
| Common shares: no par, authorized 100,000; issued and outstanding 58,453 and 57,043 as of July 3, 2010 and January 2, 2010, respectively | | |

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| | | |
|--|------------|------------|
| Additional paid-in capital | 595,141 | 557,418 |
| Accumulated deficit | (4,947) | (30,321) |
| Accumulated other comprehensive loss: | | |
| Unrealized loss on investments | (1,355) | (648) |
| Cumulative translation adjustments | (3,067) | (1,321) |
| Total accumulated other comprehensive loss | (4,422) | (1,969) |
| Total Shareholders' Equity | 585,772 | 525,128 |
| Total Liabilities and Shareholders' Equity | \$ 809,304 | \$ 747,883 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents**THORATEC CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)****(in thousands, except per share data)**

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| Product sales | \$ 95,098 | \$ 69,222 | \$ 194,370 | \$ 133,851 |
| Cost of product sales | 30,579 | 26,780 | 62,150 | 47,051 |
| Gross profit | 64,519 | 42,442 | 132,220 | 86,800 |
| Operating expenses: | | | | |
| Selling, general and administrative | 21,065 | 23,862 | 42,906 | 44,343 |
| Research and development | 11,812 | 10,327 | 31,803 | 21,100 |
| Amortization of purchased intangible assets | 2,468 | 2,359 | 4,880 | 5,082 |
| Total operating expenses | 35,345 | 36,548 | 79,589 | 70,525 |
| Income from operations | 29,174 | 5,894 | 52,631 | 16,275 |
| Other income and (expense): | | | | |
| Interest expense and other | (3,275) | (3,040) | (6,155) | (5,906) |
| Interest income and other | 1,293 | 1,313 | 2,899 | 2,244 |
| Impairment on investment | (46) | | (2,046) | |
| Income before income taxes | 27,146 | 4,167 | 47,329 | 12,613 |
| Income tax expense | (9,609) | (1,281) | (16,428) | (3,558) |
| Net income from continuing operations | 17,537 | 2,886 | 30,901 | 9,055 |
| Net loss from discontinued operations (net of tax) | (1,583) | (1,054) | (2,514) | (1,596) |
| Net income | \$ 15,954 | \$ 1,832 | \$ 28,387 | \$ 7,459 |
| Net income (loss) per share Basic: | | | | |
| Continuing operations | \$ 0.30 | \$ 0.05 | \$ 0.54 | \$ 0.16 |
| Discontinued operations | (0.02) | (0.02) | (0.05) | (0.03) |
| Net income | \$ 0.28 | \$ 0.03 | \$ 0.49 | \$ 0.13 |
| Net income (loss) per share Diluted: | | | | |
| Continuing operations | \$ 0.29 | \$ 0.05 | \$ 0.52 | \$ 0.16 |
| Discontinued operations | (0.02) | (0.02) | (0.04) | (0.03) |
| Net income | \$ 0.27 | \$ 0.03 | \$ 0.48 | \$ 0.13 |

Shares used to compute net income (loss) per share(1):

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 57,635 | 55,789 | 57,139 | 55,658 |
| Diluted | 66,436 | 57,161 | 65,986 | 57,014 |

See notes to unaudited condensed consolidated financial statements.

(1) See Note 16, Net Income (Loss) Per Share, for the computation of basic and diluted net income (loss) per share calculations using the two-class method.

Table of Contents

THORATEC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

| | Six Months Ended | |
|--|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 |
| Cash flows from continuing operating activities: | | |
| Net income from continuing operations | \$ 30,901 | \$ 9,055 |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities: | | |
| Depreciation and amortization | 8,219 | 8,758 |
| Investment premium amortization, net | 2,492 | 1,329 |
| Loss on extinguishment of senior subordinated convertible notes | 99 | |
| Non-cash expenses, net | 591 | 547 |
| Non-cash interest expense | 4,133 | 3,820 |
| Impairment on investment | 2,046 | |
| Tax benefit related to stock options | 10,013 | 1,832 |
| Share-based compensation expense | 6,653 | 5,477 |
| Excess tax benefits from share-based compensation | (9,265) | (1,594) |
| Loss on disposal of assets | 74 | 104 |
| Change in net deferred tax liability | (3,577) | (4,504) |
| Changes in assets and liabilities: | | |
| Receivables | (4,325) | (1,860) |
| Inventories | (6,032) | (5,057) |
| Prepaid expenses and other assets | 272 | (570) |
| Accounts payable and other liabilities | 8,328 | (3,065) |
| Prepaid income taxes, net | (21,780) | 854 |
| Net cash provided by continuing operating activities | 28,842 | 15,126 |
| Cash flows from continuing investing activities: | | |
| Purchases of available-for-sale investments | (300,576) | (90,237) |
| Sales of available-for-sale investments | 229,863 | 25,808 |
| Maturities of available-for-sale investments | 32,090 | 44,773 |
| Restricted cash and cash equivalents | | (20,000) |
| Purchases of patents | (1,414) | |
| Purchases of property, plant and equipment | (2,133) | (4,420) |
| Net cash used in continuing investing activities | (42,170) | (44,076) |
| Cash flows from continuing financing activities: | | |
| Excess tax benefits from share-based compensation | 9,265 | 1,594 |
| Proceeds from stock option exercises | 21,779 | 2,925 |
| Proceeds from stock issued under employee stock purchase plan | 1,884 | 1,628 |
| Repurchase and retirement of common shares | (4,505) | (3,100) |
| Extinguishment of senior subordinated convertible notes | (5,345) | |

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| | | |
|---|-----------|-----------|
| Net cash provided by continuing financing activities | 23,078 | 3,047 |
| Effect of exchange rate changes on cash and cash equivalents | (102) | (91) |
| Net increase (decrease) in cash and cash equivalents from continuing operations | 9,648 | (25,994) |
| Cash and cash equivalents from continuing operations at beginning of period | 27,787 | 108,388 |
| Cash and cash equivalents from continuing operations at end of period | \$ 37,435 | \$ 82,394 |
| Cash flows from discontinued operations: | | |
| Net cash provided by operating activities | \$ 2,495 | \$ 1,950 |
| Net cash used in investing activities | (1,746) | (1,535) |
| Net increase in cash from discontinued operations | 749 | 415 |
| Bank overdraft from discontinued operations at beginning of period | (1,326) | (1,335) |
| Bank overdraft from discontinued operations at end of period | \$ (577) | \$ (920) |
| Supplemental disclosure of consolidated cash flow information: | | |
| Cash paid for taxes | \$ 29,562 | \$ 4,852 |
| Cash paid for interest | \$ 1,707 | \$ 1,707 |
| Supplemental disclosure of consolidated non-cash investing and financing activities: | | |
| Transfers of equipment from inventory | \$ 2,029 | \$ 1,120 |
| Purchases of property, plant and equipment through accounts payable and accrued liabilities | \$ 34 | \$ 370 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Operations and Significant Accounting Policies*Basis of Presentation*

The interim unaudited condensed consolidated financial statements of Thoratec Corporation (we, our, us, or the Company) have been prepared and presented in accordance with accounting principles generally accepted in the United States of America (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC), without audit, and reflect all adjustments necessary (consisting only of normal recurring adjustments) to present fairly our financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. The accompanying financial statements should be read in conjunction with our fiscal 2009 consolidated financial statements, and the accompanying notes thereto, filed with the SEC in our Annual Report on Form 10-K (the 2009 Annual Report). The operating results for any interim period are not necessarily indicative of the results that may be expected for any future period.

The preparation of our unaudited condensed consolidated financial statements necessarily requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities on the unaudited condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented. The actual amounts could differ from those estimated amounts.

The financial information presented herein includes continuing operations, unless otherwise stated. On April 25, 2010, our board of directors made a decision to sell International Technidyne Corporation (ITC) and expects to complete this sale within a year. As such, in the second quarter of 2010, ITC has met the conditions in Financial Accounting Standards Board (FASB) Codification (ASC) 360, *Property, Plant and Equipment*, to be classified as an asset held for sale for all periods presented, as described in Note 15, *Assets Held for Sale*.

Revenue Recognition and Product Warranty

We recognize revenue from product sales when evidence of an arrangement exists, and title has passed (generally upon shipment) or services have been rendered, the selling price is fixed or determinable and collectability is reasonably assured. Sales to distributors are recorded when title transfers.

The majority of our products are covered by up to a one-year limited manufacturer's warranty. Estimated contractual warranty obligations are recorded when related sales are recognized and any additional amounts are recorded when such costs are probable, can be reasonably estimated and are included in Cost of product sales. The change in accrued warranty expense is summarized in the following table:

| | Three Months | | Six Months Ended | |
|--------------------------------|-----------------------|----------------|-------------------------|----------------|
| | Ended | | | |
| | July 3, | July 4, | July 3, | July 4, |
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Balance at beginning of period | \$ 1,777 | \$ 705 | \$ 1,706 | \$ 554 |
| Accruals for warranties issued | 1,182 | 1,122 | 1,931 | 1,900 |
| Settlements made | (1,212) | (631) | (1,890) | (1,258) |
| Balance at end of period | \$ 1,747 | \$ 1,196 | \$ 1,747 | \$ 1,196 |

Table of Contents**2. Recently Issued Accounting Standards**

In July 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-20, *Receivables (Topic 320): Disclosures About Credit Quality of Financing Receivables and the Allowance for Credit Losses*. ASU No. 2010-20 provides accounting guidance which expands disclosures regarding the credit quality of an entity's receivables portfolio and its related allowance for credit losses. This ASU No. 2010-20 amended guidance is effective for us commencing in the third quarter of 2011. We are currently evaluating the effect of the amended guidance on our unaudited condensed consolidated financial statements.

In April 2010, the FASB issued ASU No. 2010-17, *Revenue Recognition (Topic 605): Milestone Method*. ASU No. 2010-17 provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. Under the milestone method of revenue recognition, consideration that is contingent upon achievement of a milestone in its entirety can be recognized as revenue in the period in which the milestone is achieved only if the milestone meets all criteria to be considered substantive. ASU No. 2010-17 provides the criteria to be met for a milestone to be considered substantive which includes that: (i) performance consideration earned by achieving the milestone be commensurate with either performance to achieve the milestone or the enhancement of the value of the item delivered as a result of a specific outcome resulting from performance to achieve the milestone; and (ii) relate to past performance and be reasonable relative to all deliverables and payment terms in the arrangement. ASU No. 2010-17 is effective on a prospective basis for us for milestones achieved on or after January 2, 2011. Earlier application is permitted. We are currently evaluating the application date and the effect of the amended guidance on our unaudited condensed consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU No. 2010-06 amends ASC 820 and includes separate roll forward activity in Level 3 fair value measurements for purchases, sales, issuances and settlements. This amendment is effective after fiscal year 2010. We are currently evaluating the application of this standard on our unaudited condensed consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (a consensus of the FASB Emerging Issues Task Force)*, which amends ASC 605-25, *Revenue Recognition: Multiple-Element Arrangements*. ASU No. 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how to allocate consideration to each unit of accounting in the arrangement. This ASU replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable. ASU No. 2009-13 also eliminates the use of the residual value method for determining the allocation of arrangement consideration. Additionally, ASU No. 2009-13 requires expanded disclosures. This ASU will become effective for revenue arrangements entered into or materially modified after our fiscal year 2010. Earlier application is permitted with required transition disclosures based on the period of adoption. We are currently evaluating the application date and the impact of this standard on our unaudited condensed consolidated financial statements.

3. Cash and Cash Equivalents

Cash and cash equivalents are defined as short-term, highly liquid investments with original maturities of 90 days or less at the date of purchase. The fair value of these investments was determined by using quoted prices for identical investments in active markets.

4. Investments in Available-for-Sale Securities

Our investment portfolio is comprised of short-term and long-term investments. Investments classified as short-term available-for-sale consist primarily of municipal bonds, corporate bonds, commercial paper and variable demand notes. All investments mature within two years or less from the date of purchase. Investments with maturities beyond one year may be classified as short-term, if they are available and intended for use in current operations, based on their highly liquid nature or due to the frequency with which the interest rate is reset. Investments classified as long-term available-for-sale consist of auction rate securities, whose underlying assets are student loans. In addition, our long-term investments associated with the deferred compensation plans are classified as trading and consist of the cash surrender value of our corporate owned life insurance policies.

Our investments in available-for-sale securities are recorded at estimated fair value on our financial statements, and the temporary differences between cost and estimated fair value are presented as a separate component of accumulated other comprehensive loss.

Table of Contents

As of July 3, 2010, we had unrealized gains before tax from our investment in municipal bonds and corporate bonds of \$1.3 million and unrealized losses before tax from our auction rate securities of \$3.5 million.

The aggregate market value, cost basis and gross unrealized gains and losses for available-for-sale investments as of July 3, 2010 and January 2, 2010 by major security type are as follows:

| | Amortized cost | Gross unrealized gains (losses) (in thousands) | Fair value |
|-------------------------|---------------------------|---|-----------------------|
| July 3, 2010: | | | |
| Short-term investments: | | | |
| Municipal bonds | \$ 250,969 | \$ 1,028 | \$ 251,997 |
| Variable demand notes | 45,605 | | 45,605 |
| Corporate bonds | 13,865 | 265 | 14,130 |
| Commercial paper | 2,992 | | 2,992 |
| Total | \$ 313,431 | \$ 1,293 | \$ 314,724 |
| Long-term investments: | | | |
| Auction rate securities | \$ 27,700 | \$ (3,534) | \$ 24,166 |
| January 2, 2010: | | | |
| Short-term investments: | | | |
| Municipal bonds | \$ 196,650 | \$ 1,526 | \$ 198,176 |
| Variable demand notes | 66,865 | | 66,865 |
| Corporate bonds | 13,785 | 348 | 14,133 |
| Total | \$ 277,300 | \$ 1,874 | \$ 279,174 |
| Long-term investments: | | | |
| Auction rate securities | \$ 27,700 | \$ (3,066) | \$ 24,634 |

As of July 3, 2010, we owned approximately \$27.7 million face amount of auction rate securities classified as long-term. The assets underlying these investments are student loans backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically every seven to thirty-five days. Beginning in February of 2008, these auctions began to fail. The principal amount of these auction rate securities will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption, or they are paid at maturity.

As a result of these auction failures, these auction rate securities do not have a readily determinable market value. We estimated fair values as of July 3, 2010 using a discounted cash flow model based on estimated interest rates, the present value of future principal and interest payments discounted at rates considered to reflect current market conditions, and the credit quality of the underlying securities. Specifically, our management estimated the future cash flows over a five-year period, and applied a credit default rate to reflect the risk in the marketplace for these investments has arisen due to the lack of an active market.

As of July 3, 2010 we recorded an estimated cumulative unrealized loss of \$3.5 million (\$2.1 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive loss within shareholders' equity. In addition, our management reviews impairments and credit losses associated with its investments, including auction rate securities, to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of other-than-temporary impairment event. We (i) do not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; (ii) intend to hold the investment to recovery and, based on a more-likely-than-not probability assessment, will not be required to sell the security before recovery; and (iii) deem that it is not probable that we will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the impairment was charged to other comprehensive loss. Our auction rate securities are classified as long-term valued at \$24.2 million using significant unobservable inputs. Subsequent to the second quarter of 2010 we liquidated \$3.0 million of our auction rate securities at par value through a successful auction.

Table of Contents

If the issuers of the auction rate securities are unable to successfully complete future auctions and their credit ratings deteriorate, we may in the future be required to record an impairment charge to earnings on these investments. It could conceivably take until the final maturity of the underlying notes (up to 30 years) to realize the investments carrying value.

The aggregate market value of our trading investments included in our deferred compensation plan as of July 3, 2010 and January 2, 2010 were as follows:

| | July 3, 2010 | January 2, 2010 |
|----------------------------|-------------------------|----------------------------|
| | (in thousands) | |
| Deferred compensation plan | \$ 2,357 | \$ 2,436 |

The investments associated with the deferred compensation plans are included in Other long-term assets on our condensed consolidated balance sheets at the fair value of the cash surrender value of our corporate owned life insurance policies. The realized loss before tax from the change in the fair value of the cash surrender value for the three months ended July 3, 2010 of approximately \$0.2 million and for the six months ended July 3, 2010 of approximately \$80,000 is included in Interest income and other.

5. Fair Value Measurements

ASC 820, *Fair Value Measurements and Disclosure*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, we used various approaches, including market, income and/or cost approaches, and each of these approaches requires certain inputs. Fair value measurement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions as compared to the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

We value our financial and nonfinancial assets and liabilities based on the observability of inputs used in the valuation of such assets and liabilities using the following fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial and nonfinancial assets and liabilities carried or disclosed at fair value were classified and disclosed in one of the following three categories:

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

Level 2: Quoted prices of similar investments in active markets, of similar or identical investments in markets that are not active or model based valuations for which all significant inputs and value drivers are observable, directly or indirectly.

Level 3: Inputs that are unobservable and significant to the overall fair value measurement.

Table of Contents

The following table represents the hierarchy of our financial assets and financial liabilities measured at fair value on a recurring basis:

| | July 3, 2010 | | | | |
|---|---|-----------------------------|--|--|--|
| | Assets and liabilities at carrying value | Total fair value | Quoted prices in active markets for identical assets (Level 1) (in thousands) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets | | | | | |
| Short-term investments: | | | | | |
| Municipal bonds | \$ 251,997 | \$ 251,997 | \$ | \$ 251,997 | \$ |
| Variable demand notes | 45,605 | 45,605 | | 45,605 | |
| Corporate bonds | 14,130 | 14,130 | | 14,130 | |
| Commercial paper | 2,992 | 2,992 | | 2,992 | |
| Prepaid expenses and other assets mark to market on foreign exchange instruments (Note 6) | 3 | 3 | | 3 | |
| Long-term investments - auction rate securities | 24,166 | 24,166 | | | 24,166 |
| Other long-term assets - deferred compensation plan | 2,357 | 2,357 | | 2,357 | |
| Liabilities | | | | | |
| Make-whole provision (Note 10) | 15 | 15 | | | 15 |
| January 2, 2010 | | | | | |
| | Assets and liabilities at carrying value | Total fair value | Quoted prices in active markets for identical assets (Level 1) (in thousands) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets | | | | | |
| Short-term investments: | | | | | |
| Municipal bonds | \$ 198,176 | \$ 198,176 | \$ | \$ 198,176 | \$ |
| Variable demand notes | 66,865 | 66,865 | | 66,865 | |
| Corporate bonds | 14,133 | 14,133 | | 14,133 | |
| | 8 | 8 | | 8 | |

| | | | |
|---|--------|--------|--------|
| Prepaid expenses and other assets mark to market on foreign exchange instruments (Note 6) | | | |
| Long-term investments - auction rate securities | 24,634 | 24,634 | 24,634 |
| Other long-term assets - deferred compensation plan | 2,436 | 2,436 | 2,436 |
| Liabilities | | | |
| Make-whole provision (Note 10) | 23 | 23 | 23 |

Assets measured at fair value on a recurring basis using significant unobservable Level 3 inputs consist of securities with an auction reset feature (auction rate securities) whose underlying assets are student loans issued by various tax-exempt state agencies, most of which are supported by federal government guarantees and some of which are supported by private insurers. To estimate the fair value of the auction rate securities, the present value of future cash flows are estimated by discounting future principal and interest payments over a five year period. Significant inputs which vary by issuer include (1) basis point spread of 0.54% per annum (2) credit default rate which ranges from 1.35% to 6.59% and (3) discount yield rate of 1.82%.

Our short-term available-for-sale investments, which are recorded at fair value, are valued using quoted prices of similar or like securities that are traded in active markets. Our foreign exchange instruments are measured at fair value using internal models based on observable market inputs such as forward prices and exchange rates. Our long-term available-for-sale investments are measured at fair value based on unobservable market inputs using a discounted cash flow model based on estimated interest rates, the present value of future principal and interest payments discounted at rates considered to reflect current market conditions, and the credit quality of the underlying securities. Our carrying value of investments on our deferred compensation plan is recorded at fair value of similar securities that are traded in markets that are not active.

Table of Contents

The make-whole provision is measured at fair value, using valuation techniques, based on an internal model using observable inputs such as our stock price, the volatility of our stock, and unobservable inputs such as the probability of the Company being acquired and the probability of the type of consideration used by a potential acquirer.

The following table provides a reconciliation of the beginning and ending balances for the assets and liabilities measured at fair value using significant unobservable inputs (Level 3):

| | Fair Value Measurement Using Significant Unobservable Inputs (Level 3) | |
|--|---|--------------------|
| | Auction Rate | |
| | Securities | Liabilities |
| | (in thousands) | |
| Balance at January 2, 2010 | \$ 24,634 | \$ 23 |
| Unrealized holding gain on make-whole provision, included in interest income and other | | (11) |
| Unrealized holding loss on auction rate securities, included in other comprehensive income | (688) | |
| Balance as of April 3, 2010 | \$ 23,946 | \$ 12 |
| Unrealized holding loss on make-whole provision, included in interest income and other | | 3 |
| Unrealized holding gain on auction rate securities, included in other comprehensive income | 220 | |
| Balance as of July 3, 2010 | \$ 24,166 | \$ 15 |

We continue to monitor the market for auction rate securities and consider its impact (if any) on the fair value of our investments. If the current market conditions deteriorate further, or the anticipated recovery in fair values does not occur, we may be required to record additional unrealized losses in other comprehensive income or other-than-temporary impairment charges to the condensed consolidated statements of operations in future periods.

In addition, we are using significant unobservable Level 3 inputs for the fair value of our convertible debenture with Levitronix, LLC as of July 3, 2010 and January 2, 2010 of \$2.4 million and \$3.0 million, respectively. This convertible debenture is recorded at the carrying value of \$2.8 million as of both July 3, 2010 and January 2, 2010, and is included in Other long-term assets on the condensed consolidated balance sheets. Levitronix repaid the receivable balance of approximately \$2.8 million in full on August 3, 2010.

Senior subordinated convertible notes measured at fair value on a recurring basis using Level 2 inputs include quoted prices of identical or similar liabilities and are measured at a fair value of \$316.8 million and \$205.4 million, as of July 3, 2010 and January 2, 2010, respectively. The senior subordinated convertible notes have been reclassified to current liabilities during the second quarter of 2010 due to a redemption feature which may require us to repurchase all or a portion of the senior subordinated convertible notes as early as May 16, 2011. For a detailed discussion, see Note 10 Senior Subordinated Convertible Notes.

6. Foreign Exchange Instruments

We utilize foreign currency forward exchange contracts and options to mitigate against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions (primarily assets and liabilities on our U.K. subsidiary's consolidated balance sheet). We do not use

derivative financial instruments for speculative or trading purposes. We routinely hedge our exposure to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. If a financial counterparty to any of our hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency forward contract, we may experience material financial losses.

Table of Contents

The impacts of the current foreign currency contracts with a maximum maturity of three months, which do not qualify for hedge accounting, were as follows:

| | Notional Amounts | |
|-----------|-------------------------|---------------------|
| | July 3, 2010 | July 4, 2009 |
| | (in thousands) | |
| Purchases | \$ | \$ 8,414 |
| Sales | 12,860 | 11,973 |

Effective January 3, 2010, we changed our functional currency for our U.K subsidiary from U.K pounds to euros. This change did not have a material impact on our condensed consolidated financial statements; however the change did impact our foreign currency hedging contracts. As of July 3, 2010, we owned forward contracts to sell euros to U.S. dollars with a notional value of 7.1 million, to sell U.S. dollars to euro with a notional value of \$2.3 million and to sell U.K. pounds to euros with a notional value of £1.0 million, as compared to July 4, 2009, when we owned forward contracts to sell euros to U.S dollars with a notional value of 8.5 million and to purchase U.K. pounds from U.S. dollars with a notional value of £5.1 million. As of July 3, 2010, our forward contracts had an average exchange rate of one U.S. dollar to 1.2546 euros and one U.K. pound to 1.2094 euros. The fair value of these contracts is \$3,000 and is included in Prepaid expenses and other assets in our condensed consolidated balance sheets.

The following represents our realized fair value of the foreign currency contracts and offsets to the foreign currency exchange gains and losses which were included in Interest income and other in the condensed consolidated statements of operations:

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Foreign currency exchange gain on foreign currency contracts | \$ 482 | \$ 487 | \$ 746 | \$ 935 |
| Foreign currency exchange loss on foreign translation adjustments | (296) | (498) | (626) | (1,448) |

7. Inventories

Inventories are stated at the lower of cost or market. Cost is based on the first in, first out method and consisted of the following:

| | July 3, 2010 | January 2, 2010 |
|-----------------|-------------------------|----------------------------|
| | (in thousands) | |
| Finished goods | \$ 10,102 | \$ 12,920 |
| Work in process | 11,739 | 7,350 |
| Raw materials | 26,664 | 24,365 |
| Total | \$ 48,505 | \$ 44,635 |

8. Property, Plant and Equipment, net

Property, plant and equipment, net, consisted of the following:

| July 3, 2010 | January 2, 2010 |
|-------------------------|----------------------------|
| (in thousands) | |

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| | | |
|--------------------------------------|-----------|-----------|
| Land, building and improvements | \$ 18,305 | \$ 18,134 |
| Equipment and capitalized software | 39,316 | 38,281 |
| Furniture and leasehold improvements | 21,052 | 20,655 |
| Subtotal | 78,673 | 77,070 |
| Less accumulated depreciation | (41,567) | (39,955) |
| Total | \$ 37,106 | \$ 37,115 |

Table of Contents**9. Goodwill and Purchased Intangible Assets**

The carrying amount of goodwill was \$95.0 million as of July 3, 2010 and January 2, 2010.

In February 2001, we merged with Thermo Cardiosystems, Inc. The components of identifiable intangible assets related to the merger include: patents and trademarks, core technology (Thoralon, our proprietary bio-material), and developed technology (patented technology, other than core technology, acquired in the merger).

During the first quarter of 2010, we purchased patents at a fair value of \$1.4 million, which we capitalized under ASC 350, *Intangibles - Goodwill and Other*. These patents have an estimated useful life of approximately ten years.

The purchased intangibles on the condensed consolidated balance sheets are summarized as follows:

| | July 3, 2010 | | |
|-----------------------------------|--------------------------------------|--|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization (in thousands) | Net Carrying Amount |
| Patents and trademarks | \$ 40,832 | \$ (30,143) | \$ 10,689 |
| Core technology | 37,180 | (16,530) | 20,650 |
| Developed technology | 121,805 | (59,735) | 62,070 |
| Total purchased intangible assets | \$ 199,817 | \$ (106,408) | \$ 93,409 |

| | January 2, 2010 | | |
|-----------------------------------|--------------------------------------|--|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization (in thousands) | Net Carrying Amount |
| Patents and trademarks | \$ 39,418 | \$ (29,625) | \$ 9,793 |
| Core technology | 37,180 | (15,558) | 21,622 |
| Developed technology | 121,805 | (56,344) | 65,461 |
| Total purchased intangible assets | \$ 198,403 | \$ (101,527) | \$ 96,876 |

Amortization expense related to purchased intangible assets for the three months ended July 3, 2010 and July 4, 2009 was \$2.5 million and \$2.4 million, respectively. Amortization expense related to purchased intangible assets for the six months ended July 3, 2010 and July 4, 2009 was \$4.9 million and \$5.1 million, respectively. Our amortization expense is expected to be approximately \$9.7 million in 2010, declining to \$8.7 million by 2014. This decline in amortization expense is due to certain intangibles being fully amortized. Patents and trademarks have useful lives ranging from eight to ten years, and core and developed technology assets have useful lives ranging from zero to eleven years.

10. Senior Subordinated Convertible Notes

In 2004, we completed the sale of \$143.8 million initial principal amount of senior subordinated convertible notes due in 2034. The convertible notes were sold to Qualified Institutional Buyers pursuant to the exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Rule 144A thereunder.

The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Beginning on May 16, 2011, the original issue discount will accrue daily at a rate of 2.375% per year on a semi-annual bond equivalent basis and, on the maturity date, a holder will receive \$1,000 per note. As a result, the aggregate principal amount of the outstanding

notes at maturity will be \$243.4 million.

Table of Contents

Holders of the senior subordinated convertible notes may convert their convertible notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on October 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of our common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, we may, at our option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes. As of July 3, 2010, 4,035 bonds of the 247,427 bonds originally issued had been submitted to be converted and we have elected to pay cash in lieu of shares for these bonds.

Holders may require us to repurchase all or a portion of their senior subordinated convertible notes on each of May 16, 2011, 2014, 2019, 2024 and 2029 at a repurchase price equal to 100% of the issue price, plus accrued original issue discount, if any. Based on this redemption feature, we reclassified the net carrying amount of the senior subordinated notes to current liabilities during the second quarter of 2010. In addition, if we experience a change in control or a termination of trading of our common stock each holder may require the Company to purchase all or a portion of such holder's notes at the same price, plus, in certain circumstances, to pay a make-whole premium. This premium is considered an embedded derivative and has been bifurcated from the senior subordinated convertible notes and recorded at its estimated fair value, \$15,000 as of July 3, 2010. There are significant variables and assumptions used in valuing the make-whole provision including, but not limited to, our stock price, the volatility of our stock, the probability of the Company being acquired and the probability of the type of consideration used by a potential acquirer.

The senior subordinated convertible notes are subordinated to all of our senior indebtedness and structurally subordinated to all indebtedness of our subsidiaries. Therefore, in the event of a bankruptcy, liquidation or dissolution of the Company or one or more of our subsidiaries and acceleration of or payment default on our senior indebtedness, holders of the convertible notes will not receive any payment until holders of any senior indebtedness we may have outstanding have been paid in full.

In accordance with ASC 470-20, *Debt*, which applies to certain convertible debt instruments that may be settled in cash or other assets, or partially in cash, upon conversion, we recorded the debt and equity components on the senior subordinated convertible notes separately. This accounting pronouncement increased interest expense associated with our senior subordinated convertible notes by adding a non-cash component to amortize a debt discount calculated based on the difference between the cash coupon rate (2.375% per year) of the senior subordinated convertible notes and the effective interest rate on debt borrowing (9% per year). The discount, which represents the non-cash interest expense, classified as interest expense on the condensed consolidated statements of operations, is being amortized to interest expense over a seven-year period ending May 16, 2011 (the expected life of the liability component) using the effective interest method. Additionally, we allocated transaction costs on the same percentage as the liability and equity component, such that a portion of the deferred debt issuance costs is allocated to the liability component to be amortized using the effective interest method until May 16, 2011, and the equity component to be included in additional paid-in capital.

Table of Contents

Interest expense primarily includes interest and amortization of discount related to senior subordinated convertible notes as follows:

| | Three Months Ended | | Six Months Ended | |
|-------------------------------------|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Interest expense cash component | \$ 847 | \$ 853 | \$ 1,701 | \$ 1,706 |
| Interest expense non-cash component | 2,052 | 1,910 | 4,139 | 3,820 |

The debt and equity component (recorded in additional paid-in-capital, net of income tax benefit) consisted of the following:

| | July 3, 2010 | January 2, 2010 |
|---|-------------------------|----------------------------|
| | (in thousands) | |
| Senior subordinated convertible notes | | |
| Principal amount | \$ 141,406 | \$ 143,750 |
| Unamortized discount | (7,524) | (11,821) |
| Net carrying amount | \$ 133,882 | \$ 131,929 |
| Equity component, net of income tax benefit | \$ 25,325 | \$ 28,462 |

We may redeem either in whole or in part any of the senior subordinated convertible notes at any time beginning May 16, 2011, by giving the holders at least 30 days notice, at a redemption price equal to the sum of the issue price and the accrued original issue discount. If the holders converted the senior subordinated convertible notes into shares of our stock as of July 3, 2010, the if-converted value would be \$309.8 million, based on our stock price of \$43.20 per share on July 2, 2010, which amount exceeds the original value of the bonds outstanding, or \$141.4 million, by \$168.4 million. This if-converted value is \$66.4 million more than the \$243.4 million face amount of the outstanding bonds at maturity in 2034.

The aggregate fair value of the senior subordinated convertible notes at July 3, 2010 was \$316.8 million.

11. Comprehensive Income

Comprehensive income refers to revenues, expenses, gains and losses that under generally accepted accounting principles are included in accumulated other comprehensive income or loss, a component of shareholders' equity within the condensed consolidated balance sheets, rather than the condensed consolidated statements of operations. Under our existing accounting standards, comprehensive income includes unrecognized gains and losses on investments and currency translation adjustments.

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Net income from continuing operations | \$ 17,537 | \$ 2,886 | \$ 30,901 | \$ 9,055 |
| Unrealized gains (losses) on investments (net of taxes of \$31 and \$1,595 for the three months ended July 3, 2010 and July 4, 2009, respectively, and \$471 and \$1,531 for the six months ended July 3, 2010 and July 4, 2009, respectively) | (47) | 2,393 | (707) | 2,297 |
| Foreign currency translation adjustments | (940) | 1,229 | (1,746) | 1,276 |

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| | | | | |
|---|-----------|----------|-----------|-----------|
| Comprehensive income from continuing operations | 16,550 | 6,508 | 28,448 | 12,628 |
| Comprehensive loss from discontinued operations | (1,583) | (1,054) | (2,514) | (1,596) |
| Comprehensive income | \$ 14,967 | \$ 5,454 | \$ 25,934 | \$ 11,032 |

There are no reconciling items between net loss from discontinued operations and comprehensive loss from discontinued operations.

15

Table of Contents**12. Share-Based Compensation**

Share-based compensation expense is measured based on the grant-date fair value of the share-based awards. We recognize share-based compensation expense for the portion of the award that is expected to vest over the requisite service period for those awards with graded vesting and service conditions. We develop an estimate of the number of share-based awards which will ultimately vest, primarily based on historical experience. The estimated forfeiture rate is re-assessed periodically throughout the requisite service period. Such estimates are revised if they differ materially from actual forfeitures. As required, the forfeiture estimates will be adjusted to reflect actual forfeitures when an award vests.

Share-based compensation expense and related stock option and restricted stock award activity is presented on a consolidated basis, unless otherwise presented as continuing operations and discontinued operations.

Share-based compensation included in the condensed consolidated statements of operations consists of the following:

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Cost of product sales | \$ 359 | \$ 261 | \$ 626 | \$ 555 |
| Selling, general and administrative | 1,895 | 1,665 | 4,216 | 3,544 |
| Research and development | 809 | 585 | 1,811 | 1,398 |
| Total share-based compensation expense before taxes | 3,063 | 2,511 | 6,653 | 5,497 |
| Tax benefit for share-based compensation expense | 1,405 | 956 | 2,800 | 1,959 |
| Total share-based compensation continuing operations (net of taxes) | \$ 1,658 | \$ 1,555 | \$ 3,853 | \$ 3,538 |
| Total share-based compensation discontinued operations (net of taxes) | \$ 718 | \$ 852 | \$ 1,656 | \$ 1,784 |

As of July 3, 2010 and July 4, 2009, share-based compensation expense of \$0.3 million and \$0.2 million, respectively, was capitalized to inventory.

We receive a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the fair market value of the options at the date of exercise over the exercise prices of the options. Our unaudited condensed consolidated statements of cash flows presentation reports the excess tax benefits (i.e., windfall only for tax deductions in excess of the share-based compensation expense recognized) as financing cash flows of \$9.3 million and \$1.6 million for the six months ended July 3, 2010 and July 4, 2009, respectively.

Cash proceeds from the exercise of stock options were \$21.8 million and \$2.9 million for the six months ended July 3, 2010 and July 4, 2009, respectively. Cash proceeds from our employee stock purchase plan were \$1.9 million and \$1.6 million for the six months ended July 3, 2010 and July 4, 2009, respectively. The Company purchased \$4.5 million and \$3.1 million of restricted stock for payment of income tax withholding due upon vesting for the six months ended July 3, 2010 and July 4, 2009, respectively.

Table of Contents**Equity Plan**

In April 2006, the Board of Directors approved the 2006 Incentive Stock Plan (2006 Plan). In May 2006 the 2006 Plan was amended by the Board of Directors and approved by our shareholders, in May 2008 the 2006 Plan was further amended by the Board of Directors and approved by our shareholders and in May 2010 the 2006 Plan was further amended by the Board of Directors and approved by our shareholders. The 2006 Plan allows us to grant to our employees, directors and consultants up to a total of 8.6 million shares of stock awards. Each share issued from May 20, 2008 through May 18, 2010 as restricted stock bonuses, restricted stock units, phantom stock units, performance share bonuses, or performance share units reduces the number of shares available for issuance under the 2006 Plan by one and seventy-four hundredths (1.74) shares, and each share issued as stock options, restricted stock purchases or stock appreciation rights reduced the shares available for issuance under the 2006 Plan on a share-for-share basis. Each share issued from and after May 19, 2010 as restricted stock bonuses, restricted stock units, phantom stock units, performance share bonuses, or performance share units reduces the number of shares available for issuance under the 2006 Plan by one and seven-tenths (1.7) shares, and each share issued as stock options, restricted stock purchases or stock appreciation rights reduces the shares available for issuance under the 2006 Plan on a share-for-share basis. During the six months ended July 3, 2010, approximately 443,000 options were granted under the 2006 Plan at an exercise price equal to the fair market value on the date of grant, and approximately 580,000 shares of restricted stock and restricted stock units were granted under the 2006 Plan. As of July 3, 2010, approximately 3.9 million shares remained available for grant under the 2006 Plan.

Stock Options

Upon approval in May 2006, the 2006 Plan replaced our previous common stock option plans and equity incentive plans. As of July 3, 2010, we had 2.9 million options issued and outstanding under the 2006 Plan and the replaced plans. Options under the 2006 Plan may be granted by the Board of Directors at the fair market value on the date of grant and generally become fully exercisable within four years after the grant date and expire between five and ten years from the date of grant. Vesting on some options granted to officers may be accelerated in certain circumstances following a change in control of the Company.

The fair value of each option is estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|---------------------|-------------------------|---------------------|
| | July | | July | |
| | 3, | July 4, 2009 | 3, 2010 | July 4, 2009 |
| Risk-free interest rate (weighted average) | 2.87% | 2.97% | 3.05% | 2.32% |
| Expected volatility | 40% | 53% | 40% | 53% |
| Expected option term (years) | 4.82 | 4.91 to 6.02 | 4.88 to 6.04 | 4.90 to 6.04 |
| Dividends | None | None | None | None |

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term of options represents the period of time that options are expected to be outstanding. We use separate assumptions for groups of employees (for example, officers) that have similar historical exercise behavior. The range above reflects the expected option impact of these separate groups. We base the expected volatility on a combination of historical volatility trends and market-based implied volatility because we have determined that this combination of historical volatility trends and market-based implied trends are reflective of market conditions.

At July 3, 2010, there was \$5.0 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to stock options, which expense we expect to recognize over a weighted average period of 1.63 years. At July 3, 2010, there was \$1.1 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to stock options, which expense we expect to recognize over a weighted average period of 1.63 years. The aggregate intrinsic value of in-the-money options outstanding was \$67.9 million, based on the closing price of our common stock on July 2, 2010, the last trading day in the six months ended July 3, 2010, of \$43.20. As of July 3, 2010, the aggregate intrinsic value of options currently exercisable was

\$48.8 million and the intrinsic value of options vested and expected to vest was \$66.7 million.

Table of Contents

The total intrinsic value of options exercised for the three months ended July 3, 2010 and July 4, 2009 was \$27.3 million and \$1.7 million, respectively. The total intrinsic value of options exercised for the six months ended July 3, 2010 and July 4, 2009 was \$32.0 million and \$2.6 million, respectively.

Stock option activity is summarized as follows:

| | Number of Options (in thousands) | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contract Life (years) |
|---|---|--|---|
| Outstanding options at January 2, 2010 | 3,857 | \$ 17.29 | 5.60 |
| Granted | 443 | 30.17 | |
| Exercised | (1,361) | 16.01 | |
| Forfeited or expired | (31) | 19.43 | |
| Outstanding options at July 3, 2010 | 2,908 | \$ 19.83 | 6.16 |
| Outstanding options exercisable at July 3, 2010 | 1,897 | \$ 17.49 | 4.84 |
| Outstanding options vested at July 3, 2010 and expected to vest | 2,724 | \$ 19.42 | 5.97 |

The weighted average grant-date fair value of options granted during the six months ended July 3, 2010 and July 4, 2009 was \$12.61 per share and \$12.03 per share, respectively.

Restricted Stock Awards and Units

The 2006 Plan allows for the issuance of restricted stock awards and restricted stock units, which awards or units may not be sold or otherwise transferred until certain restrictions have lapsed. The unearned share-based compensation related to these awards is being amortized to compensation expense over the period of the restrictions, generally four years. The expense for these awards was determined based on the market price of our shares on the date of grant applied to the total number of shares that were granted.

Restricted Stock Awards

Share-based compensation expense from continuing operations related to restricted stock awards was \$1.7 million for the six months ended July 3, 2010. As of July 3, 2010, we had \$2.8 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to restricted stock awards, which amount we expect to recognize over 1.29 years. As of July 3, 2010, we had \$0.9 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to restricted stock awards, which amount we expect to recognize over 1.29 years. There were no restricted stock awards granted during the six months ended July 3, 2010.

Restricted stock activity is summarized as follows:

| | Number of Shares (in thousands) | Weighted Average Grant Date Fair Value |
|--|--|---|
| Outstanding unvested restricted stock at January 2, 2010 | 609 | \$ 16.63 |
| Granted | | |
| Vested | (264) | 17.08 |
| Forfeited or expired | (18) | 16.03 |

| | | | |
|---|-----|----|-------|
| Outstanding unvested restricted stock at July 3, 2010 | 327 | \$ | 16.31 |
|---|-----|----|-------|

Restricted Stock Units

Share-based compensation expense from continuing operations related to restricted stock units was \$2.5 million for the six months ended July 3, 2010. As of July 3, 2010, we had \$15.0 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to restricted stock units, which amount we expect to recognize over 3.30 years. As of July 3, 2010, we had \$4.6 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to restricted stock units, which amount we expect to recognize over 3.30 years. The aggregate intrinsic value of the units outstanding, based on our stock price on July 2, 2010, was \$38.2 million.

Table of Contents

Restricted stock unit activity is summarized as follows:

| | Number of Units (in thousands) | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contract Life (in years) |
|--------------------------------------|---|--|---|
| Outstanding units at January 2, 2010 | 463 | \$ 24.17 | 3.12 |
| Granted | 580 | 30.82 | |
| Released | (136) | 25.15 | |
| Forfeited or expired | (22) | 25.68 | |
| Outstanding units at July 3, 2010 | 885 | \$ 28.34 | 3.30 |

Employee Stock Purchase Plan

In May 2002, our shareholders approved our Employee Stock Purchase Plan (ESPP) under which 500,000 shares of common stock were reserved for issuance. In addition, the ESPP provides for an annual, automatic increase of up to 250,000 shares in the total number of shares available for issuance thereunder on March 1 of each year, unless our Board of Directors specifies a smaller increase or no increase. Under this provision, an additional 250,000 shares were reserved for issuance under the ESPP on each of March 1, 2006, March 1, 2008 and March 1, 2009; our Board of Directors specified no increase as of each other year. Eligible employees may purchase a limited number of shares, over a six month period, of our common stock at 85% of the lower of the market value on the offering date or the market value on the purchase date. During the six months ended July 3, 2010, 83,791 shares of common stock were issued under the ESPP. As of July 3, 2010, approximately 215,909 shares remained available for issuance under this plan.

The estimated subscription date fair value of the current offering under the ESPP is approximately \$0.6 million using the Black-Scholes option pricing model and the following assumptions:

| | |
|-------------------------|------------|
| Risk-free interest rate | 0.25% |
| Expected volatility | 43% |
| Expected option life | 0.50 years |
| Dividends | None |

As of July 3, 2010, there was approximately \$0.2 million of unrecognized compensation expense from continuing operations and \$0.2 million of unrecognized expense from discontinued operations related to ESPP subscriptions that began on May 1, 2010, which amount we expect to recognize during the second half of 2010.

13. Income Taxes

Our effective income tax rates for the three months ended July 3, 2010 and July 4, 2009, were 35.4% and 30.7%, respectively. Our effective income tax rates for the six months ended July 3, 2010 and July 4, 2009 were 34.7% and 28.2%, respectively. The increase in our reported income tax rates are primarily due to the reduced impact that tax exempt income has on our tax rate due to our pretax increase in earnings. In addition, federal research credits which were available in 2009 are not currently available in 2010 as a result of the expiration of federal research credit legislation. Also in the first quarter of 2009, we recorded a discrete benefit to reflect the change in California tax law that will permit us to make a beneficial apportionment election in 2011.

During the next twelve months, it is reasonably possible that audit resolutions and the expiration of statutes of limitations could potentially reduce our unrecognized tax benefits by up to \$4.8 million. However, this amount may change because we continue to have ongoing negotiations with various taxing authorities throughout the year.

Table of Contents**14. Geographic Information**

Our functional entities operate in two segments: Cardiovascular and ITC. Due to our intent to sell ITC, segment disclosure is no longer presented. For a discussion of our ITC segment, which is classified as discontinued operations, refer to Note 15, Assets Held for Sale. Our Cardiovascular segment is classified as continuing operations.

Our geographic information for our product revenue sold by our continuing operations to the domestic and international markets is discussed below.

Revenue attributed to a country or region includes product sales to hospitals, physicians and distributors and is based on final destination where the products are sold. During the three and six months ended July 3, 2010 and July 4, 2009, no customer or international country represented individually greater than 10% of the Company's total product sales. The geographic composition of the Company's product sales from continuing operations was as follows:

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Domestic | \$ 79,906 | \$ 56,014 | \$ 162,144 | \$ 108,032 |
| International | 15,192 | 13,208 | 32,226 | 25,819 |
| Total product sales from continuing operations | \$ 95,098 | \$ 69,222 | \$ 194,370 | \$ 133,851 |

15. Assets Held For Sale

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher Corporation (Danaher) for \$110.0 million in cash upon closing, subject to certain purchase price adjustments as set forth in the agreement. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheets as of July 3, 2010 and January 2, 2010 and its results of operations displayed in discontinued operations for all periods presented.

On July 26, 2010, the sale was terminated as a result of the failure of the parties to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next twelve months.

The results of the ITC business are included in discontinued operations in the second quarter and first half of 2010 and 2009 as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands) | | | |
| Product sales | \$ 24,182 | \$ 22,836 | \$ 46,488 | \$ 47,674 |
| Cost of product sales | 16,723 | 14,523 | 30,857 | 29,692 |
| Gross profit | 7,459 | 8,313 | 15,631 | 17,982 |
| Operating expenses: | | | | |
| Selling, general and administrative | 7,551 | 6,914 | 14,179 | 13,887 |
| Research and development | 3,019 | 3,099 | 6,096 | 6,412 |
| Amortization of purchased intangible assets | 67 | 209 | 269 | 418 |
| Total operating expenses | 10,637 | 10,222 | 20,544 | 20,717 |
| Loss from operations | (3,178) | (1,909) | (4,913) | (2,735) |

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| | | | | |
|---------------------------------------|------------|------------|------------|------------|
| Other income: | | | | |
| Other income | 103 | 324 | 204 | 380 |
| Loss before income taxes | (3,075) | (1,585) | (4,709) | (2,355) |
| Income tax benefit | 1,492 | 531 | 2,195 | 759 |
| Net loss from discontinued operations | \$ (1,583) | \$ (1,054) | \$ (2,514) | \$ (1,596) |

Table of Contents

The assets and liabilities of ITC are classified as held for sale as of July 3, 2010 and January 2, 2010. Such amounts are comprised of the following:

| | July 3, 2010 | | January 2, 2010 (1) |
|---|-------------------------|-----------|--------------------------------|
| | (in thousands) | | |
| ASSETS | | | |
| Current assets: | | | |
| Receivables, net of allowances of \$383 and \$522, respectively | \$ 14,591 | \$ | 18,030 |
| Inventories (1) | 22,272 | | 22,300 |
| Prepaid expenses and other assets | 632 | | 881 |
| Total current assets | 37,495 | | 41,211 |
| Property, plant and equipment, net (2) | 15,783 | | 14,737 |
| Goodwill | 4,271 | | 4,271 |
| Purchased intangible assets, net | 2,715 | | 2,984 |
| Other long-term assets | 584 | | 595 |
| Total assets held for sale | \$ 60,848 | \$ | 63,798 |
| LIABILITIES | | | |
| Current liabilities: | | | |
| Bank overdraft | \$ 577 | \$ | 1,326 |
| Accounts payable | 2,891 | | 2,310 |
| Accrued compensation | 4,647 | | 4,990 |
| Other accrued liabilities | 2,550 | | 2,305 |
| Total current liabilities | 10,665 | | 10,931 |
| Other long-term liabilities | 1,419 | | 1,446 |
| Total liabilities related to assets held for sale | \$ 12,084 | \$ | 12,377 |

(1) Management has elected to classify the assets and liabilities of ITC as held for sale as of January 2, 2010 to conform to current presentation.

(2) Inventories classified as held for sale consisted of the

following:

| | July 3, 2010 | January 2, 2010 |
|-----------------|-------------------------|----------------------------|
| | (in thousands) | |
| Finished goods | \$ 4,740 | \$ 5,083 |
| Work in process | 2,885 | 3,068 |
| Raw materials | 14,647 | 14,149 |
| Total | \$ 22,272 | \$ 22,300 |

(3) Property, plant and equipment, net, classified as held for sale consisted of the following:

| | July 3, 2010 | January 2, 2010 |
|--------------------------------------|-------------------------|----------------------------|
| | (in thousands) | |
| Land, building and improvements | \$ 4,600 | \$ 4,606 |
| Equipment and capitalized software | 36,841 | 35,465 |
| Furniture and leasehold improvements | 3,176 | 3,098 |
| Subtotal | 44,617 | 43,169 |
| Less accumulated depreciation | (28,834) | (28,432) |
| Total | \$ 15,783 | \$ 14,737 |

Table of Contents**16. Net Income (Loss) Per Share**

On January 4, 2009, we adopted authoritative accounting guidance that requires participating securities to be included in the calculation of the net income (loss) per share using the two-class method. Our restricted share awards subject to repurchase and settled in shares of common stock upon vesting have non-forfeitable rights to receive dividends on an equal basis with common stock and therefore are considered participating securities. Under the two-class method, basic and diluted net income (loss) per common share is determined by calculating net income (loss) per share for common stock and participating securities based on participation rights in undistributed earnings. Dilutive net income (loss) per common share also considers the dilutive effect of the in-the-money stock options and restricted stock units, calculated using the treasury stock method. Under the treasury stock method, the amount of assumed proceeds from unexercised stock options and restricted stock units includes the amount of unrecognized compensation cost attributable to future services, assumed proceeds from the exercise of the options, and the incremental income tax benefit or liability that would be recorded in additional-paid-in capital when the award becomes deductible.

Basic and diluted net income (loss) per common share attributable to common shareholders under the two-class method were calculated as follows:

| | Three Months Ended | | Six Months Ended | |
|--|--|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands, except per share data) | | | |
| <i>Basic net income per share calculation</i> | | | | |
| Net income from continuing operations | \$ 17,537 | \$ 2,886 | \$ 30,901 | \$ 9,055 |
| Net income from continuing operations allocated to participating securities | (103) | (35) | (224) | (123) |
| Net income from continuing operations attributable to common shareholders | \$ 17,434 | \$ 2,851 | \$ 30,677 | \$ 8,932 |
| Net loss from discontinued operations | \$ (1,583) | \$ (1,054) | \$ (2,514) | \$ (1,596) |
| Net loss from discontinued operations allocated to participating securities | 9 | 13 | 18 | 22 |
| Net loss from discontinued operations attributable to common shareholders | \$ (1,574) | \$ (1,041) | \$ (2,496) | \$ (1,574) |
| Net income | \$ 15,954 | \$ 1,832 | \$ 28,387 | \$ 7,459 |
| Net income allocated to participating securities | (94) | (22) | (206) | (102) |
| Net income attributable to common shareholders | \$ 15,860 | \$ 1,810 | \$ 28,181 | \$ 7,357 |
| Weighted average number of common shares used to compute basic net income per common share | 57,635 | 55,789 | 57,139 | 55,658 |
| Basic net income (loss) per common share from: | | | | |
| Continuing operations | \$ 0.30 | \$ 0.05 | \$ 0.54 | \$ 0.16 |

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| | | | | |
|-------------------------|---------|---------|---------|---------|
| Discontinued operations | (0.02) | (0.02) | (0.05) | (0.03) |
| Total | \$ 0.28 | \$ 0.03 | \$ 0.49 | \$ 0.13 |

Table of Contents

| | Three Months Ended | | Six Months Ended | |
|---|--|-------------------------|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands, except per share data) | | | |
| <i>Diluted net income(loss) per common share calculation</i> | | | | |
| Net income from continuing operations | \$ 17,537 | \$ 2,886 | \$ 30,901 | \$ 9,055 |
| Interest expense on senior subordinated convertible notes (after tax) | 1,750 | | 3,524 | |
| Net income for diluted share calculation | 19,287 | 2,886 | 34,425 | 9,055 |
| Net income from continuing operations allocated to participating securities | (99) | (34) | (218) | (122) |
| Net income from continuing operations attributable to common shareholders | \$ 19,188 | \$ 2,852 | \$ 34,207 | \$ 8,933 |
| Net loss from discontinued operations | \$ (1,583) | \$ (1,054) | \$ (2,514) | \$ (1,596) |
| Net income from discontinued operations allocated to participating securities | 9 | 13 | 18 | 22 |
| Net loss from discontinued operations attributable to common shareholders | \$ (1,574) | \$ (1,041) | \$ (2,496) | \$ (1,574) |
| Net income | \$ 15,954 | \$ 1,832 | \$ 28,387 | \$ 7,459 |
| Interest expense on senior subordinated convertible notes (after tax) | 1,750 | | 3,524 | |
| Net income for diluted share calculation | 17,704 | 1,832 | 31,911 | 7,459 |
| Net income allocated to participating securities | (91) | (22) | (202) | (100) |
| Net income attributable to common shareholders | \$ 17,613 | \$ 1,810 | \$ 31,709 | \$ 7,359 |
| Weighted average number of common shares used to compute basic net income (loss) per common share attributable to common shares | 57,635 | 55,789 | 57,139 | 55,658 |
| Dilutive effect of stock-based compensation plans | 1,540 | 1,372 | 1,571 | 1,356 |
| Dilutive effect on conversion of senior subordinated convertible notes | 7,261 | | 7,276 | |
| Weighted average number of common shares used to compute diluted net income (loss) per common share | 66,436 | 57,161 | 65,986 | 57,014 |

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| | | | | |
|---|---------|---------|---------|---------|
| Diluted net income (loss) per common share from | | | | |
| Continuing operations | \$ 0.29 | \$ 0.05 | \$ 0.52 | \$ 0.16 |
| Discontinued operations | (0.02) | (0.02) | (0.04) | (0.03) |
| Total | \$ 0.27 | \$ 0.03 | \$ 0.48 | \$ 0.13 |

The weighted average unvested restricted stock awards outstanding were 342,305 and 679,138 for the three months ended July 3, 2010 and July 4, 2009, respectively. The weighted average unvested restricted stock awards outstanding were 418,432 and 767,653 for the six months ended July 3, 2010 and July 4, 2009, respectively.

Table of Contents

Subsequent to the original issuance of the unaudited condensed consolidated financial statements for the period ended July 4, 2009, management determined that the net income (loss) per share calculations for the three and six months ended July 4, 2009 did not properly reflect the restricted share awards as participating securities under the two-class method and thus were inappropriately reflected in the number of common shares to be used in the computation of net income (loss) per share. The change to the calculation of the two-class method had no impact on the reported net income (loss) per share for the three and six months ended July 4, 2009. The change to the calculation of the two-class method resulted in a decrease in the shares reported as used in the computation of both basic and diluted net income (loss) per share of approximately 679,000 and 768,000 for the three and six months ended July 4, 2009, respectively. The shares previously included in the calculations of basic and diluted net income (loss) per share for the three months and six months ended July 4, 2009 were as follows:

| | Three Months Ended July 4, 2009 | Six Months Ended July 4, 2009 |
|---------|--|--|
| | (in thousands) | |
| Basic | 56,468 | 56,426 |
| Diluted | 57,840 | 57,782 |

Potential common share equivalents excluded where the inclusion would be anti-dilutive are as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|----------------|-------------------------|----------------|
| | July | July 4, | July | July 4, |
| | 3, | 2009 | 3, | 2009 |
| | (in thousands) | | | |
| Options to purchase shares not included in the computation of diluted income per share because their inclusion would be anti-dilutive | 21 | 344 | 297 | 253 |

Options to purchase shares not included in the computation of diluted income per share because their inclusion would be anti-dilutive

The computation of diluted net income per common share for the three and six months ended July 4, 2009 excludes the effect of assuming the conversion of our senior subordinated convertible notes, which are convertible at \$19.72 per share into 7.3 million shares of common stock, because the effect would have been anti-dilutive.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Forward-Looking Statements**

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements can be identified by the words expects, projects, hopes, believes, intends, should, estimate, will, would, may, anticipates, plans, could and other similar words. Actual results, events or performance could differ materially from these forward-looking statements based on a variety of factors, many of which are beyond our control. Therefore, readers are cautioned not to put undue reliance on these statements. Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described in the Risk Factors section of our 2009 Annual Report on Form 10-K (the 2009 Annual Report) and in other documents we file with the Securities and Exchange Commission (SEC). These forward-looking statements speak only as of the date hereof. We are not under any obligation, and we expressly disclaim any obligation, to publicly release any revisions or updates to these forward-looking statements that may be made to reflect events or circumstances after the date hereof, or to reflect the occurrence of unanticipated events.

The following presentation of management's discussion and analysis of our financial condition and results of operations should be read together with our unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q.

OVERVIEW**Continuing Operations Cardiovascular Business**

Thoratec Corporation (we, our, us, or the Company) is the world leader in mechanical circulatory support with a product portfolio to treat the full range of clinical needs for advanced heart failure patients. We develop, manufacture and market proprietary medical devices used for circulatory support.

For advanced heart failure (HF), we develop, manufacture and market proprietary medical devices used for mechanical circulatory support (MCS). Our primary product lines are our ventricular assist devices (VADs): the Thoratec Paracorporeal Ventricular Assist Device (PVAD), the Thoratec Implantable Ventricular Assist Device (IVAD), the HeartMate Left Ventricular Assist System (HeartMate XVE), and the HeartMate II Left Ventricular Assist System (HeartMate II). We refer to the PVAD and the IVAD collectively as the Thoratec product line and we refer to the HeartMate XVE and the HeartMate II collectively as the HeartMate product line. The PVAD, IVAD, HeartMate XVE and HeartMate II are approved by the U.S Food and Drug Administration (FDA) and are Conformite Europeene (CE) Mark approved in Europe. In addition, for acute HF we market the CentriMag Blood Pumping System (CentriMag), which is manufactured by Levitronix LLC (Levitronix) and distributed by us in the U.S. under a distribution agreement with Levitronix. We also manufacture a vascular access graft for renal dialysis.

VADs supplement the pumping function of the heart in patients with advanced HF. In most cases, a cannula connects the left ventricle of the heart to a blood pump. Blood flows from the left ventricle to the pump chamber via the cannula, powered by an electric or air driven mechanism that drives the blood through another cannula into the aorta. From the aorta, the blood then circulates throughout the body. Mechanical or tissue valves enable unidirectional flow in some devices. Currently, the power source remains outside the body for all FDA-approved VADs.

Certain VADs are implanted internally, while others are placed outside the body. Some external devices are placed immediately adjacent to the body (paracorporeal), while other external VADs are positioned at a distance from the body (extracorporeal).

In addition to our MCS devices, we sell vascular access graft products used in hemodialysis for patients with late-stage renal disease.

Our product portfolio of implantable and external MCS devices and graft products is described below.

Table of Contents***The HeartMate II***

The HeartMate II is an implantable, electrically powered, continuous flow, left ventricular assist device consisting of a miniature rotary blood pump designed to provide intermediate and long-term MCS. The HeartMate II is designed to improve survival and quality of life and to provide five to ten years of circulatory support for a broad range of advanced HF patients. Significantly smaller than the HeartMate XVE and with only one moving part, the HeartMate II is simpler and designed to operate more quietly than pulsatile devices. Effective January 20, 2010, the HeartMate II can be used in patients with New York Heart Association Class IIIB and IV end-stage left ventricular failure who have received optimal medical therapy for at least forty-five of the last sixty days, and who are not candidates for cardiac transplantation.

HeartMate II received FDA approval in April 2008 for bridge-to-transplantation (BTT) and received FDA approval for use in HF patients who are not eligible for heart transplantation (Destination Therapy or DT) in January 2010. In November 2005, the HeartMate II received CE Mark approval, allowing for its commercial sale in Europe. In May 2009, the HeartMate II was approved in Canada.

During the third quarter of 2009 we launched our new HeartMate external peripherals (Go-Gear), including new batteries, charger and power module, which are designed to provide an enhanced quality of life for HeartMate patients by providing them more freedom and mobility and the ability to more easily resume many aspects of a normal lifestyle.

The HeartMate XVE

The HeartMate XVE is an implantable, pulsatile, left ventricular assist device for intermediate and longer-term MCS. Patients with a HeartMate XVE do not require anticoagulation drugs, other than aspirin, because of the product's incorporation of proprietary textured surfaces and tissue valves. The system is comprised of the blood pump and a wearable controller and batteries providing a high degree of patient freedom and mobility.

The HeartMate XVE received FDA approval for BTT in December 2001 and for Destination Therapy in April 2003. In June 2003, the HeartMate XVE received CE Mark approval, allowing for its commercial sale in Europe. In June 2004, the HeartMate XVE was approved in Canada.

The Paracorporeal Ventricular Assist Device

The PVAD is an external, pulsatile, ventricular assist device, FDA approved for BTT, including home discharge, and post-cardiotomy myocardial recovery and provides left, right and biventricular MCS. The PVAD is a paracorporeal device that is less invasive than implantable VADs since only the cannula is implanted. The paracorporeal nature of the PVAD has several benefits including shorter implantation times (approximately two hours) and the ability to use the device in smaller patients.

A pneumatic power source drives the PVAD. It is designed for short-to-intermediate duration use of a few weeks to several months, although this device has supported numerous patients for nine to eighteen months. Offering left, right or biventricular support, the PVAD and the IVAD, described below, are the only biventricular support systems approved for use as BTT. This characteristic is significant because approximately 50% of BTT patients treated with the PVAD and the IVAD require right as well as left-sided ventricular assistance. The PVAD and the IVAD are also the only devices approved for both BTT and recovery following cardiac surgery. The PVAD incorporates our proprietary biomaterial, Thoralon, which has excellent tissue and blood compatibility and is resistant to blood clots.

The PVAD received FDA approval for BTT in December 1995 and for recovery (post-cardiotomy) in May 1998. In June 1998, the PVAD received CE Mark approval, allowing for its commercial sale in Europe. In November 1994, the PVAD was approved in Canada.

Table of Contents

The Implantable Ventricular Assist Device

The IVAD is an implantable, pulsatile, ventricular assist device FDA approved for BTT, including home discharge, and post-cardiotomy myocardial recovery and provides left, right or biventricular MCS. The IVAD maintains the same blood flow path, valves and blood pumping mechanism as the PVAD, but has an outer housing made of a titanium alloy that makes it suitable for implantation.

The IVAD received FDA approval for BTT and recovery (post-cardiotomy) in August 2004. In June 2003, the IVAD received CE Mark approval, allowing for its commercial sale in Europe. In November 2004, the IVAD was approved in Canada.

The CentriMag

The CentriMag is manufactured by Levitronix and is based on their magnetically levitated bearingless motor technology. We entered into a distribution agreement with Levitronix in August 2007, with an initial term effective through December 2011, to distribute the CentriMag in the U.S. The CentriMag is 510(k) cleared by the FDA for use up to six hours in patients requiring short-term extracorporeal circulatory support during cardiac surgery.

Additionally, CentriMag is approved under a FDA humanitarian device exemption to be used as a right ventricular assist device for periods of support up to thirty days in patients in cardiogenic shock due to acute right ventricular failure. In May 2008, Levitronix received approval to commence a U.S. pivotal trial to demonstrate safety and effectiveness of the CentriMag for periods of support up to thirty days. Levitronix has CE Mark approval in Europe to market the product to provide support for up to thirty days.

Vascular Graft Products

The Vectra Vascular Access Graft (Vectra) was approved for sale in the U.S. in December 2000 and in Europe in January 1998. It is designed for use as a shunt between an artery and a vein, primarily to provide access to the bloodstream for renal hemodialysis patients requiring frequent needle punctures during treatment.

Discontinued Operations International Technidyne Corporation (ITC)

Our ITC division develops, manufactures and markets two product lines:

Point-of-Care Diagnostics. Our point-of-care products include diagnostic test systems that monitor blood coagulation while a patient is being administered certain anticoagulants, as well as monitor blood gas/electrolytes, oxygenation and chemistry status.

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

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher Corporation (Danaher) for \$110.0 million in cash upon closing, subject to certain purchase price adjustments as set forth in the agreement. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheet as of July 3, 2010 and January 2, 2010 and its results of operations displayed in discontinued operations for all periods presented.

On July 26, 2010, the sale was terminated as a result of the failure of the parties to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next twelve months.

Table of Contents

Critical Accounting Policies and Estimates

We have identified the policies and estimates below as critical to our business operations and the understanding of our results of operations. The impact of, and any associated risks related to, these policies and estimates on our business operations are discussed below. Preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities. There can be no assurance that actual results will not differ from those estimates and assumptions.

Revenue Recognition

We recognize revenue from product sales when evidence of an arrangement exists, title has passed (generally upon shipment) or services have been rendered, the selling price is fixed or determinable and collectability is reasonably assured. Sales to distributors are recorded when title transfers.

We recognize sales of certain products to first-time customers when it has been determined that the customer has the ability to use the products. These sales frequently include the sale of products and training services under multiple element arrangements. Training is not considered essential to the functionality of the products. Revenue under these arrangements is allocated to training based upon fair market value of the training, which is typically performed on our behalf by third party providers. Under this method, the total value of the arrangement is allocated to the training and the products based on the relative fair market value of the training and products.

In determining when to recognize revenue, management makes decisions on such matters as the fair values of the product and training elements when sold together, customer credit worthiness and warranty reserves. If any of these decisions proves incorrect, the carrying value of these assets and liabilities on our unaudited condensed consolidated balance sheets or the recorded product sales could be significantly different, which could have a material adverse effect on our results of operations for any fiscal period.

Reserves

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make payments owed to us for product sales and training services. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

The majority of our products are covered by up to a one-year limited manufacturer's warranty from the date of shipment or installation. Estimated contractual warranty obligations are recorded when the related sales are recognized and any additional amounts are recorded when such costs are probable and can be reasonably estimated, at which time they are included in Cost of product sales in our unaudited condensed consolidated statements of operations. In determining the warranty reserve estimate, management makes judgments and estimates on such matters as repair costs and probability of warranty obligations.

Estimated excess and obsolete inventory charges are recorded when inventory levels exceed projected sales volume for a certain period of time. In determining the excess obsolete charges, management makes judgments and estimates on matters such as forecasted sales volume. If sales volume does not meet projections, additional write-downs may be required.

Management must make estimates and judgments to determine the amount of reserves to accrue. If any of these decisions proves incorrect, our condensed consolidated financial statements could be materially and adversely affected.

Table of Contents***Income Taxes***

We make certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments occur in the calculation of tax credits, benefits and deductions, such as tax benefits from our non-U.S. operations and in the calculation of certain tax assets and liabilities, which arise from differences in the timing of revenue and expense for tax and financial statement purposes.

We record a valuation allowance to reduce our deferred tax assets to an amount that more-likely-than-not will be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the allowance for the deferred tax asset would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the valuation allowance for the deferred tax asset would be charged to income in the period such determination was made.

We believe we have provided adequate reserves for uncertain tax positions for anticipated audit adjustments by U.S. federal, state and local, as well as foreign, tax authorities based on our estimate of whether, and the extent to which, additional taxes, interest and penalties may be due. If events occur which indicate payment of these amounts is unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the accrued liabilities are no longer warranted. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

Evaluation of Purchased Intangible Assets and Goodwill for Impairment

We periodically evaluate the carrying value of long-lived assets to be held and used, including intangible assets subject to amortization, when events or circumstances warrant such a review. The carrying value of a long-lived asset to be held and used is considered impaired when the anticipated separately-identifiable undiscounted cash flows to be generated by such an asset are less than the carrying value of the asset. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Management must make estimates of these future cash flows, and if necessary, the approximate discount rate, and if any of these estimates proves incorrect, the carrying value of these assets on our unaudited condensed consolidated balance sheets could become significantly impaired.

Purchased intangible assets with indefinite lives and goodwill are not amortized but are subject to annual impairment tests. If there was impairment, a new fair value would be determined. If the new fair value is less than the carrying amount, an impairment loss would be recognized.

Valuation of Share-Based Awards

Share-based compensation expense is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of option awards at the grant date requires judgment, including estimating the expected term of stock options, the expected volatility of our stock, expected forfeitures and expected dividends. The computation of the expected volatility assumption used in the Black-Scholes option pricing model for option grants is based on a combination of our historical volatility and market-based implied volatility. When establishing the expected life assumption, we review annual historical employee exercise behavior of option grants with similar vesting periods. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual forfeitures differ significantly from these estimates, share-based compensation expense and our results of operations could be materially affected.

Table of Contents***Fair Value Measurements***

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date.

In determining fair value, we use various approaches, including market, income and/or cost approaches, and each of these approaches requires certain inputs. Fair value measurement standards establish a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions as compared to the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access. Assets and liabilities utilizing Level 1 inputs include broker-dealer quoted securities that are traded in an active market. Since valuations are based on quoted prices that are readily and regularly available in an active market, a significant degree of judgment is not required.

Level 2 Valuations based on quoted prices of similar investments in active markets, of similar or identical investments in markets that are not active or model based valuations for which all significant inputs and value drivers are observable, directly or indirectly. Assets and liabilities utilizing Level 2 inputs primarily include municipal bonds, variable demand notes, corporate bonds, commercial paper, carrying value of investments on our deferred compensation plan and our senior subordinated convertible notes, except the make-whole provision, which uses Level 3 inputs, described below.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Assets and liabilities utilizing Level 3 inputs include auction rate securities, our convertible debenture with Levitronix, our purchased intangible asset valuations and the make-whole feature of our senior subordinated convertible notes. Given the current credit market illiquidity for auction rate securities, our estimates are subject to significant judgment by management.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, our own assumptions are developed to reflect those that market participants would use in pricing the asset or liability at the measurement date. See Note 5, Fair Value Measurements, to the unaudited condensed consolidated financial statements for further information about our financial assets that are accounted for at fair value.

Due to the uncertainty inherent in the valuation process, estimates of fair value may differ significantly from the values that would have been obtained had an active market for the securities existed, and the differences could be material. After determining the fair value of our available-for-sale securities, gains or losses on these investments are recorded to other comprehensive income, until either the investment is sold or we determine that the decline in value is other-than-temporary. Determining whether the decline in fair value is other-than-temporary requires management judgment based on the specific facts and circumstances of each investment. For investments in available-for-sale securities, these judgments primarily consider: our ability and intent to hold the investment to maturity, whether it is more-likely-than-not that we would be required to sell the investment before recovery of the investments amortized cost basis and whether we expect to recover the amortized cost basis of the investment. Given the current market conditions, these judgments could prove to be incorrect, and companies with relatively high credit ratings and solid financial conditions may not be able to fulfill their obligations. In addition, if we decide not to hold an investment until its value recovers it may result in the recognition of an other-than-temporary impairment.

Table of Contents**Results of Operations**

The following table sets forth selected condensed consolidated statements of operations data for the periods indicated and as a percentage of total product sales:

| | Three Months Ended | | | | Six Months Ended | | | |
|---|--|------|--------------|------|------------------|------|--------------|------|
| | July 3, 2010 | | July 4, 2009 | | July 3, 2010 | | July 4, 2009 | |
| | (in thousands, except for percentage data) | | | | | | | |
| Product sales | \$ 95,098 | 100% | \$ 69,222 | 100% | \$ 194,370 | 100% | \$ 133,851 | 100% |
| Cost of product sales | 30,579 | 32 | 26,780 | 39 | 62,150 | 32 | 47,051 | 35 |
| Gross profit | 64,519 | 68 | 42,442 | 61 | 132,220 | 68 | 86,800 | 65 |
| Operating expenses: | | | | | | | | |
| Selling, general and administrative | 21,065 | 22 | 23,862 | 35 | 42,906 | 22 | 44,343 | 33 |
| Research and development | 11,812 | 12 | 10,327 | 15 | 31,803 | 16 | 21,100 | 16 |
| Amortization of purchased intangible assets | 2,468 | 3 | 2,359 | 3 | 4,880 | 3 | 5,082 | 4 |
| Total operating expenses | 35,345 | 37 | 36,548 | 53 | 79,589 | 41 | 70,525 | 53 |
| Income from operations | 29,174 | 31 | 5,894 | 8 | 52,631 | 27 | 16,275 | 12 |
| Other income and (expense): | | | | | | | | |
| Interest expense and other | (3,275) | (3) | (3,040) | (4) | (6,155) | (3) | (5,906) | (4) |
| Interest income and other | 1,293 | 1 | 1,313 | 2 | 2,899 | 1 | 2,244 | 2 |
| Impairment of investment | (46) | | | | (2,046) | (1) | | |
| Income before income taxes | 27,146 | 29 | 4,167 | 6 | 47,329 | 24 | 12,613 | 10 |
| Income tax expense | (9,609) | (10) | (1,281) | (2) | (16,428) | (8) | (3,558) | (3) |
| Net income from continuing operations | 17,537 | 18 | 2,886 | 4 | 30,901 | 16 | 9,055 | 7 |
| Net loss from discontinued operations, net of tax | (1,583) | (1) | (1,054) | (2) | (2,514) | (1) | (1,596) | (1) |
| Net income | \$ 15,954 | 17 | \$ 1,832 | 2 | \$ 28,387 | 15 | \$ 7,459 | 6 |

Three and six months ended July 3, 2010 and July 4, 2009**Continuing Operations****Product Sales**

Product sales were as follows:

| | Three Months Ended | | | Six Months Ended | | |
|---------------|---------------------------|----------------|---------------|-------------------------|----------------|---------------|
| | July 3, | July 4, | % | July 3, | July 4, | % |
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| | (in thousands) | | | (in thousands) | | |
| Product sales | \$ 95,098 | \$ 69,222 | 37% | \$ 194,370 | \$ 133,851 | 45% |

In the second quarter of 2010 as compared to the second quarter of 2009, product sales increased by \$25.9 million primarily due to higher worldwide sales of our HeartMate product line, including Go-Gear peripherals introduced in the third quarter of 2009.

In the first half of 2010 as compared to the first half of 2009, product sales increased by \$60.5 million primarily due to higher worldwide sales of our HeartMate product line, including Go-Gear peripherals, which was in part offset by a decline in the Thoratec product line. In the U.S., ten HeartMate II centers have been added in first six months of 2010 bringing the total to 130 centers. Internationally, we added eleven centers in the first six months of 2010, bringing the total to 102 centers.

Sales originating outside of the U.S. and U.S. export sales accounted for approximately 16% and 19% of our total product sales in the second quarter of 2010 and 2009, respectively, and approximately 17% and 19% of our total product sales in the first half of 2010 and 2009, respectively.

Table of Contents**Gross Profit**

Gross profit and gross margin were as follows:

| | Three Months Ended | | Six Months Ended | |
|--------------------|------------------------------------|-----------------|------------------|-----------------|
| | July 3, 2010 | July 4, 2009 | July 3, 2010 | July 4, 2009 |
| | (in thousands, except percentages) | | | |
| Total gross profit | \$ 64,519 | \$ 42,442 | \$ 132,220 | \$ 86,800 |
| Total gross margin | 68% | 61% | 68% | 65% |

In the second quarter of 2010 as compared to the second quarter of 2009, gross margin percentage increased by 6.5 percentage points, primarily attributable to favorable manufacturing variances driven by volume and the continued increase in sales of Go-Gear peripherals. In addition, in the second quarter of 2009 we recorded a \$4.3 million excess inventory reserve related to the declining utilization of the HeartMate XVE that did not reoccur in the second quarter of 2010.

In the first half of 2010 as compared to the first half of 2009, gross margin percentage increased by 3.2 percentage points, primarily attributable to favorable manufacturing variances driven by volume and the continued increase in sales of Go-Gear peripherals. In addition, in the first half of 2009 we recorded a \$4.3 million excess inventory reserve related to the declining utilization of the HeartMate XVE that did not reoccur in the first half of 2010.

Selling, General and Administrative

Selling, general and administrative expenses were as follows:

| | Three Months Ended | | | Six Months Ended | | |
|---|-----------------------------------|-----------------------------------|-------------|-----------------------------------|-----------------------------------|-------------|
| | July 3, 2010 (in thousands) | July 4, 2009 (in thousands) | % Change | July 3, 2010 (in thousands) | July 4, 2009 (in thousands) | % Change |
| Total selling, general and administration | \$ 21,065 | \$ 23,862 | (12)% | \$ 42,906 | \$ 44,343 | (3)% |

In the second quarter of 2010 as compared to the second quarter of 2009, selling, general and administrative costs decreased by \$2.8 million due to higher legal and consulting fees of \$5.6 million related to the intended acquisition of HeartWare International Inc. (HeartWare) in 2009, partially offset by \$2.8 million related to the expansion of our sales force and other market development initiatives.

In the first half of 2010 as compared to the first half of 2009, selling, general and administrative costs decreased by \$1.4 million due to higher legal and consulting fees of \$7.9 million related to the intended acquisition of HeartWare in 2009, partially offset by the expansion of our sales force and other market development initiatives, including users meetings.

Research and Development

Research and development expenses were as follows:

| | Three Months Ended | | | Six Months Ended | | |
|--|-----------------------------------|-----------------------------------|-------------|-----------------------------------|-----------------------------------|-------------|
| | July 3, 2010 (in thousands) | July 4, 2009 (in thousands) | % Change | July 3, 2010 (in thousands) | July 4, 2009 (in thousands) | % Change |
| | \$ 11,812 | \$ 10,327 | 14% | \$ 31,803 | \$ 21,100 | 51% |

Total research and
development

Research and development costs are largely project driven, and fluctuate based on the level of project activity planned and subsequently approved and conducted.

In the second quarter of 2010 as compared to the second quarter of 2009, costs increased by \$1.5 million primarily due to an increase in personnel costs associated with new HeartMate II system enhancements, cross platform initiatives and next generation pump technology.

Table of Contents

In the first half of 2010 as compared to the first half of 2009, costs increased by \$10.7 million primarily due the acquisition of PHP technology of \$8.5 million which was expensed, new HeartMate II platform enhancements, development of HeartMate III and other new product technology.

Amortization of Purchased Intangible Assets

Amortization of purchased intangible assets in the second quarter of 2010 was \$2.5 million as compared to \$2.4 million in the second quarter of 2009 and in the first half of 2010 was \$4.9 million as compared to \$5.1 million in the first half of 2009. The \$0.2 million decrease in amortization expense for the first half of 2010 was due to certain intangible assets being fully amortized.

Interest Expense and Other

Interest expense, primarily related to interest on the senior subordinated convertible notes, is as follows:

| | Three Months Ended | | | Six Months Ended | | |
|--|-----------------------------------|-----------------|-------------|-----------------------------------|-----------------|-------------|
| | July 3, 2010 (in thousands) | July 4, 2009 | % Change | July 3, 2010 (in thousands) | July 4, 2009 | % Change |
| Interest expense | \$ 3,067 | \$ 2,939 | 4% | \$ 5,844 | \$ 5,702 | 2% |
| Amortization of debt issuance costs related to senior subordinated convertible notes | 109 | 101 | 8% | 212 | 204 | 4% |
| Loss on extinguishment of senior subordinated convertible notes | 99 | | | 99 | | |
| Total interest expense | \$ 3,275 | \$ 3,040 | | \$ 6,155 | \$ 5,906 | |

Interest expense, which is comprised primarily of the senior subordinated convertible notes, is calculated using the interest rate method which increases interest expense over the term of the debt resulting in a higher expense in the second quarter and first half of 2010 as compared to the second quarter and first half of 2009. In addition, during the second quarter of 2010, 4,035 of the 247,427 bonds originally issued in the senior subordinated convertible note financing had been submitted to be converted and we had elected to pay cash in lieu of shares for these bonds, resulting in a loss on extinguishment of such notes of \$0.1 million.

Interest Income and Other

Interest income and other consisted of the following:

| | Three Months Ended | | | Six Months Ended | | |
|---------------------------------|-----------------------------------|-----------------|-------------|-----------------------------------|-----------------|-------------|
| | July 3, 2010 (in thousands) | July 4, 2009 | % Change | July 3, 2010 (in thousands) | July 4, 2009 | % Change |
| Interest income | \$ 1,206 | \$ 1,419 | (15)% | \$ 2,871 | \$ 2,723 | 5% |
| Foreign currency, net | 187 | (11) | 1,800% | 121 | (513) | 124% |
| Other | (100) | (95) | (5)% | (93) | 34 | (374)% |
| Total interest income and other | \$ 1,293 | \$ 1,313 | | \$ 2,899 | \$ 2,244 | |

Interest income in the second quarter of 2010 decreased by \$0.2 million as compared to the second quarter of 2009, primarily due to the decline in market interest rates.

Interest income in the first half of 2010 increased by \$0.1 million from the first half of 2009, mainly due to increased cash and investment balances partially offset by the decline in market interest rates and shortened maturities on our investment portfolio. Foreign currency loss decreased in the same period by \$0.6 million due to fluctuations in foreign exchange rates.

Impairment on Investment

During the first half of 2010, we recorded an impairment charge of \$2.0 million for our entire investment in Acorn Cardiovascular, Inc., a start-up medical device company.

Table of Contents***Income Taxes***

Our effective income tax rates for the three months ended July 3, 2010 and July 4, 2009 were 35.4% and 30.7%, respectively. The increase in our tax rate of 4.7 percentage points was primarily due to an increase in pre-tax earnings, and the proportion of tax exempt interest to higher pre-tax earnings.

Our effective income tax rates for the six months ended July 3, 2010 and July 4, 2009 were 34.7% and 28.2%, respectively. The increase in our tax rate of 6.5 percentage points was primarily due to an increase in pre-tax earnings, and the proportion of tax exempt interest to the higher pre-tax earnings. In addition, in the first quarter of 2009 a discrete benefit was recorded for a change in California law.

Further, both of the three month and six month periods in 2010 were affected by federal research tax credits which were available in 2009 but are not currently available in 2010 as a result of the expiration of federal research tax credit legislation.

Our effective tax rate is calculated based on the statutory tax rates imposed on projected annual pre-tax income or loss in various jurisdictions. Since changes in our forecasted profitability for 2010 can significantly affect our projected annual effective tax rate, we believe our quarterly tax rate will be dependent on our profitability and could fluctuate significantly.

Analysis of Discontinued Operations

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher Corporation for \$110.0 million in cash upon closing, subject to certain purchase price adjustments as set forth in the agreement. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheets as of July 3, 2010 and January 2, 2010 and its results of operations displayed in discontinued operations for all periods presented.

On July 26, 2010, the sale was terminated as a result of the failure of the Company and Danaher to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next twelve months.

Discontinued operations incurred a loss of \$1.6 million in the second quarter of 2010 compared to a loss of \$1.1 million in the second quarter of 2009. The increase in the loss from discontinued operations was primarily due to lower gross profits as a result of higher unfavorable manufacturing variances.

Discontinued operations incurred a loss of \$2.5 million during the first half of 2010 compared to a loss of \$1.6 million in the first half of 2009. The increase in the loss from discontinued operations was primarily due to lower gross profit as a result of higher unfavorable manufacturing variances.

Liquidity and Capital Resources***Cash, Cash Equivalents and Investments***

Cash and cash equivalents include highly liquid financial instruments that are readily convertible to cash and have maturities of 90 days or less from the date of purchase.

Investments classified as short-term consist of various financial instruments such as commercial paper, U.S. government agency obligations, variable demand notes and corporate notes. Bonds with high credit quality with maturities of greater than 90 days when purchased are classified as available-for-sale. Investments classified as long-term consist of our investments in auction rate securities.

Table of Contents

Following is a summary of our cash, cash equivalents and investments:

| | July 3, 2010 | January 2, 2010 |
|---|-------------------------|----------------------------|
| | (in thousands) | |
| Cash and cash equivalents | \$ 37,435 | \$ 27,787 |
| Short-term investments | 314,724 | 279,174 |
| Long-term investments | 24,166 | 24,634 |
| Total cash, cash equivalents and investments | \$ 376,325 | \$ 331,595 |

We believe that cash and cash equivalents, short-term available-for-sale investments on hand and expected cash flows from operations will be sufficient to fund our operations and capital requirements for at least the next twelve months.

As of July 3, 2010, we owned approximately \$27.7 million face amount of auction rate securities classified as long-term. The assets underlying these investments are student loans backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically every seven to thirty-five days. Beginning in February of 2008, these auctions began to fail. The principal amount of these auction rate securities will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption, or they are paid at maturity.

We recorded an estimated cumulative unrealized loss of \$3.5 million (\$2.1 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive loss within shareholders' equity. In addition, our management reviews impairments and credit losses associated with its investments, including auction rate securities, to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of other-than-temporary impairment event. We do not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; we intend to hold the investment to recovery and based on a more-likely-than-not probability assessment we will not be required to sell the security before recovery; and we deem that it is not probable that we will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the impairment was charged to other comprehensive loss. Further, we continue to liquidate investments in auction rate securities as opportunities arise. Subsequent to the second quarter of 2010 we liquidated \$3.0 million of our auction rate securities at par value through a successful auction.

We continue to monitor the market for auction rate securities and consider its impact (if any) on the fair value of our investments. If the current market conditions deteriorate further, or the anticipated recovery in fair values does not occur, we may be required to record additional unrealized losses in other comprehensive loss or other-than-temporary impairment charges to the condensed consolidated statements of operations in future periods.

We intend and have the ability to hold these auction rate securities until the market recovers, and the securities recover to par or until maturity. We do not anticipate having to sell these securities in order to operate our business. We believe that, based on our current cash, cash equivalents and short-term marketable security investment balances of \$352.2 million as of July 3, 2010, the current lack of liquidity in the credit and capital markets will not have an impact on our liquidity, our cash flow or our ability to fund our operations. If the issuers of the auction rate securities are unable to successfully complete future auctions and their credit ratings deteriorate, we may in the future be required to record other-than-temporary impairment charge on these investments. It could conceivably take until the final maturity of the underlying notes (up to 30 years) to realize our investments' recorded value.

Table of Contents*Senior Subordinated Convertible Notes*

In 2004, we completed the sale of \$143.8 million initial principal amount of senior subordinated convertible notes due in 2034. The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Holders of the senior subordinated convertible notes may convert their convertible notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on September 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of our common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of our common stock at a conversion rate of 29.462 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, we may, at our option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes. As of July 3, 2010, 4,035 of the 247,427 bonds originally issued had been submitted to be converted and we had elected to pay cash in lieu of shares for these bonds.

In addition, holders may require us to repurchase all or a portion of their senior subordinated convertible notes on each of May 16, 2011, 2014, 2019, 2024 and 2029 at a repurchase price equal to 100% of the issue price, plus the accrued original issue discount, if any. Due to this redemption feature, where holders may require us to repurchase all or a portion of the senior subordinated convertible notes as early as May 16, 2011, these senior subordinated convertible notes have been reclassified from long-term liabilities to current liabilities during the second quarter of 2010.

We adopted ASC 470-20, *Debt*, applied retrospectively, which increases non-cash interest expense based on the market rate of 9% percent per annum as compared to the cash coupon rate of 2.375% as further discussed in Note 10, Senior Subordinated Convertible Notes.

Cash Flow Activities from Continuing Operations

Following is a summary of our cash flow activities:

| | Six Months Ended | |
|--|-------------------------|-------------------------|
| | July 3, 2010 | July 4, 2009 |
| | (in thousands) | |
| Net cash provided by continuing operating activities | \$ 28,842 | \$ 15,126 |
| Net cash used in continuing investing activities | (42,170) | (44,076) |
| Net cash provided by continuing financing activities | 23,078 | 3,047 |
| Effect of exchange rate changes on cash and cash equivalents | (102) | (91) |
| Net increase (decrease) in cash and cash equivalents | \$ 9,648 | \$ (25,994) |

Cash Provided by Continuing Operating Activities

For the six months ended July 3, 2010, cash provided by operating activities was \$28.8 million. This amount included net income from continuing operations of \$30.9 million increased by non-cash adjustments to net income of \$21.5 million primarily comprised of \$3.3 million related to depreciation, \$4.9 million related to amortization, \$10.0 million related to tax benefit related to stock options, \$6.7 million related to share-based compensation expense, and non-cash interest on senior subordinated convertible notes of \$4.1 million. These were partially offset by a

decrease of \$9.3 million related to excess tax benefits from share-based compensation and \$3.4 million change in our net deferred tax liability. Changes in assets and liabilities used cash of \$23.5 million primarily due to increases in tax payments, inventories, and receivables, partially offset by an increase in accounts payable and other liabilities.

Cash Used in Continuing Investing Activities

For the six months ended July 3, 2010, cash used in investing activities was \$42.2 million, due to purchases of investments of \$300.6 million, partially offset by sales and maturities of investments of \$262.0 million. In addition, we made \$2.1 million of purchases of property, plant and equipment which included \$1.8 million for lab equipment related to the expansion of our research and development facilities and an increase in furniture and computers for expansion of our Pleasanton office.

Table of Contents***Cash Provided by Continuing Financing Activities***

For the six months ended July 3, 2010, cash provided by financing activities was \$23.1 million, primarily was comprised of \$21.8 million from proceeds related to stock option exercises, \$1.9 million from proceeds from stock issued under our employee stock purchase plan and \$9.3 million from excess tax benefits from stock option exercises, offset by \$4.5 million of restricted stock purchased for payment of income tax withholding due upon vesting and \$5.3 million used to extinguish notes because 4,035 of our senior subordinated convertible notes were submitted for conversion.

Cash Flow Activities from Discontinued Operations

Following is a summary of the cash flow activities from discontinued operations:

| | Six Months Ended | |
|---|-------------------------|-------------------------|
| | July 3, 2010 | July 3, 2010 |
| | (in thousands) | |
| Net cash provided by operating activities | \$ 2,495 | \$ 1,950 |
| Net cash used in investing activities | (1,746) | (1,535) |
| Net decrease in bank overdraft | \$ 749 | \$ 415 |

Off Balance Sheet Arrangements

We maintain an Irrevocable Standby Letter of Credit as part of our workers' compensation insurance program. The Letter of Credit is not collateralized. The Letter of Credit automatically renews on June 30th of each year, unless terminated by one of the parties. As of July 3, 2010, our Letter of Credit was approximately \$1.0 million.

Contractual Obligations

As of July 3, 2010, the liability for uncertain tax positions was \$10.3 million, including interest and penalties. Due to the high degree of uncertainty regarding the timing of potential future cash flows associated with these liabilities, we are unable to make a reasonably reliable estimate of the amount and period in which these liabilities might be paid.

During the three and six months ended July 3, 2010 there were no other material changes to our contractual obligations reported in our 2009 Annual Report on Form 10-K, outside our normal course of business.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**Interest Rate Risk**

Our investment portfolio is made up of marketable investments in money market funds, auction rate securities, U.S. Treasury securities and debt instruments of government agencies, local municipalities, and high quality corporate issuers. All investments are carried at fair market value and are treated as available-for-sale. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature due to the frequency with which the interest rate is reset and because such marketable securities represent the investment of cash that is available for current operations. Our auction rate securities that are not liquid are classified as long-term. Our holdings of the securities of any one issuer, except government agencies, do not exceed 10% of the portfolio. If interest rates rise, the market value of our investments may decline, which could result in a loss if we were forced to sell an investment before its scheduled maturity. If interest rates were to rise or fall from current levels by 25 basis points and by 50 basis points, the change in our net unrealized gain or loss on investments would be \$0.6 million and \$1.1 million, respectively. We do not utilize derivative financial instruments to manage interest rate risks. Our senior subordinated convertible notes and the Levitronix convertible debenture do not bear interest rate risk as the notes and debenture were issued at a fixed rate of interest.

Table of Contents**Foreign Currency Rate Fluctuations**

We use forward foreign currency contracts to mitigate the gains and losses generated by the re-measurement of non-functional currency assets and liabilities (primarily assets and liabilities on our U.K. subsidiary's consolidated balance sheet). Our contracts typically have maturities of three months or less.

Effective January 3, 2010, we changed our functional currency for our U.K. subsidiary from U.K. pounds to euros. This change did not have a material impact on our condensed consolidated financial statements however the change did impact our foreign currency hedging contracts. As of July 3, 2010, we owned forward contracts to sell euros to U.S. dollars with a notional value of \$7.1 million, to sell U.S. dollars to euro with a notional value of \$2.3 million and to sell U.K. pounds to euros with a notional value of £1.0 million as compared to July 4, 2009, when we owned forward contracts to sell euros to U.S. dollars with a notional value of \$8.5 million and purchase U.K. pounds from U.S. dollars with a notional value of £5.1 million. As of July 3, 2010, our forward contracts had an average exchange rate of one U.S. dollar to 1.2546 euros and one U.K. pound to 1.2094 euros. The potential fair value loss for a hypothetical 10% adverse change in foreign currency exchange rates as of July 3, 2010 would be approximately \$0.8 million.

ITEM 4. CONTROLS AND PROCEDURES

Attached as exhibits to this Form 10-Q are certifications of our Chief Executive Officer and Chief Financial Officer, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (the Exchange Act). This Controls and Procedures section includes information concerning the controls and controls evaluation referred to in the certifications.

Disclosure Controls and Procedures

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, as of July 3, 2010. The evaluation of our disclosure controls and procedures included a review of our processes and the effect on the information generated for use in this Quarterly Report on Form 10-Q. In the course of this evaluation, we sought to identify any significant deficiencies or material weaknesses in our disclosure controls and procedures, to determine whether we had identified any acts of fraud involving personnel who have a significant role in our disclosure controls and procedures, and to confirm that any necessary corrective action, including process improvements, was taken. This type of evaluation is done quarterly so that our conclusions concerning the effectiveness of these controls can be reported in our periodic reports filed with the SEC. The overall goals of these evaluation activities are to monitor our disclosure controls and procedures and to make modifications as necessary. We intend to maintain these disclosure controls and procedures, modifying them as circumstances warrant.

Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that as of July 3, 2010 the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer, as appropriate to allow for timely decisions regarding required disclosures.

Changes to Internal Controls

There have been no changes in our internal controls over financial reporting during the quarter ended July 3, 2010 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Table of Contents

Inherent Limitations on Controls and Procedures

Our management, including the Chief Executive Officer and the Chief Financial Officer, does not expect that our disclosure controls and procedures and our internal controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can only provide reasonable assurances that the objectives of the control system are met. The design of a control system reflects resource constraints; the benefits of controls must be considered relative to their costs. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. As these inherent limitations are known features of the financial reporting process, it is possible to design into the process safeguards to reduce, though not eliminate, these risks. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns occur because of simple error or mistake. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events. While our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, there can be no assurance that any design will succeed in achieving its stated goals under all future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. While our Chief Executive Officer and Chief Financial Officer have concluded that, as of July 3, 2010, the design of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, was effective, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this Quarterly Report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our 2009 Annual Report on Form 10-K, which could materially affect our business, financial condition or future results. The risks described in our 2009 Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

ITEM 2: UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS

There were no unregistered sales of our equity securities during the three months ended July 3, 2010.

The following table sets forth certain information about our common stock repurchased during the three months ended July 3, 2010:

| | Total number of shares purchased (2) | Average price paid per share (in thousands, except per share data) | Total number of shares purchased under publicly announced programs (1) | Approximate value of shares authorized to be purchased under publicly announced programs |
|-----------------------------------|---|--|--|---|
| April 4, 2010 through May 1, 2010 | 2.2 | \$ 35.20 | | \$ |
| May 2, 2010 through May 29, 2010 | 2.0 | 41.48 | | |
| May 30, 2010 through July 3, 2010 | 2.8 | 43.94 | | |
| Total | 7.0 | \$ 40.48 | | \$ |

(1) Our share repurchase programs, which authorized us to repurchase up to a total of \$130 million of our common shares, were announced on February 11, 2004 as a \$25 million program, on May 12, 2004 as

a \$60 million program, on July 29, 2004 as a \$25 million program and on February 2, 2006 as a \$20 million program. These programs authorize us to acquire shares in the open market or in privately negotiated transactions and do not have an expiration date. No shares were repurchased under these programs during the three months ended July 3, 2010. As of July 3, 2010, we have \$10.1 million remaining under our share repurchase programs.

- (2) Shares purchased that were not part of our publicly announced repurchase programs represent the surrender value of shares of restricted stock used to pay income taxes due upon vesting, and do not reduce the dollar value that

may yet be
purchased under
our publicly
announced
repurchase
programs.

Table of Contents

ITEM 6. EXHIBITS

2.1 Stock Purchase Agreement, dated as of April 25, 2010, by and between Thoratec Corporation and Radiometer America

10.1 Thoratec Corporation Amended and Restated 2006 Incentive Stock Plan (2)

31.1 Section 302 Certification of Chief Executive Officer.

31.2 Section 302 Certification of Chief Financial Officer.

32.1 Section 906 Certification of Chief Executive Officer.

32.2 Section 906 Certification of Chief Financial Officer.

101*** The following materials from Registrant's Quarterly Report on Form 10-Q for the quarter ended July 3, 2010, formatted in Extensible Business Reporting Language (XBRL) includes: (i) Condensed Consolidated Balance Sheets as of July 3, 2010 and January 2, 2010, (ii) Condensed Consolidated Statements of Operations for the Three and Six Months Ended July 3, 2010 and January 4, 2009, (iii) Condensed Consolidated Statements of Cash Flows for the Six Months Ended July 3, 2010 and July 4, 2009, and (iv) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.

(1) Filed as an Exhibit to Thoratec's Current Report on Form 8-K filed with the SEC on April 26, 2010 and incorporated herein by reference.

(2) Filed as an Exhibit to Thoratec's Current Report on Form 8-K filed with the SEC on May 25, 2010 and incorporated herein by reference.

Table of Contents

SIGNATURES

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

THORATEC CORPORATION

Date: August 10, 2010

/s/ Gerhard F. Burbach
Gerhard F. Burbach
Chief Executive Officer

Date: August 10, 2010

/s/ David V. Smith
David V. Smith
Executive Vice President,
Chief Financial Officer (Principal Accounting
Officer)