

AtriCure, Inc.  
Form 10-Q  
August 10, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 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 000-51470

**AtriCure, Inc.**

(Exact name of Registrant as specified in its charter)

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

**34-1940305**  
(I.R.S. Employer  
Identification No.)

**6217 Centre Park Drive**  
**West Chester, OH 45069**

(Address of principal executive offices)

**(513) 755-4100**

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): YES  NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at August 6, 2010
Common Stock, \$.001 par value	15,562,949



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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ATRICURE, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 6,854,106	\$ 8,905,425
Short-term investments	5,126,111	6,816,673
Accounts receivable, less allowance for doubtful accounts of \$10,022 and \$24,400, respectively	7,720,511	7,248,087
Inventories, net	5,988,966	4,869,708
Class action settlement recovery receivable	4,750,000	2,000,000
Other current assets	901,610	1,511,335
<b>Total current assets</b>	<b>31,341,304</b>	<b>31,351,228</b>
Property and equipment, net	2,943,284	3,008,699
Intangible assets	146,903	287,653
Other assets	322,043	334,756
<b>Total Assets</b>	<b>\$ 34,753,534</b>	<b>\$ 34,982,336</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 3,803,684	\$ 3,599,943
Accrued liabilities	3,376,489	3,979,176
Accrued class action settlement reserves	4,750,000	2,000,000
Current maturities of long-term debt and capital lease obligations	2,210,699	2,227,431
<b>Total current liabilities</b>	<b>14,140,872</b>	<b>11,806,550</b>
Long-term debt and capital lease obligations	1,675,923	2,669,666
Other liabilities	3,197,608	3,416,360
<b>Total Liabilities</b>	<b>19,014,403</b>	<b>17,892,576</b>
Commitments and contingencies (Note 7)		
Stockholders Equity:		
Common stock, \$0.001 par value, 90,000,000 shares authorized and 15,558,114 and 15,353,288 issued and outstanding, respectively	15,558	15,353
Additional paid-in capital	112,574,466	110,900,087
Accumulated other comprehensive (loss) income	(107,066)	144,290
Accumulated deficit	(96,743,827)	(93,969,970)
<b>Total Stockholders Equity</b>	<b>15,739,131</b>	<b>17,089,760</b>

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Total Liabilities and Stockholders	Equity	\$ 34,753,534	\$ 34,982,336
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See accompanying notes to condensed consolidated financial statements.

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**ATRICURE, INC. AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenue	\$ 14,192,312	\$ 13,777,950	\$ 28,144,112	\$ 27,451,853
Cost of revenue	2,963,673	3,107,816	6,236,309	6,052,474
Gross profit	11,228,639	10,670,134	21,907,803	21,399,379
Operating expenses:				
Research and development expenses	2,422,443	3,138,339	5,080,371	6,055,172
Selling, general and administrative expenses	9,239,056	8,565,233	18,950,578	17,497,376
Goodwill impairment				6,812,389
Total operating expenses	11,661,499	11,703,572	24,030,949	30,364,937
Loss from operations	(432,860)	(1,033,438)	(2,123,146)	(8,965,558)
Other income (expense):				
Interest expense	(214,867)	(278,415)	(477,881)	(339,144)
Interest income	6,281	15,593	12,935	35,835
Other	(122,951)	(157,841)	(187,446)	(181,396)
Loss before income tax expense (benefit)	(764,397)	(1,454,101)	(2,775,538)	(9,450,263)
Income tax expense (benefit)	109	(11,033)	(1,681)	(42,273)
Net loss	\$ (764,506)	\$ (1,443,068)	\$ (2,773,857)	\$ (9,407,990)
Basic and diluted net loss per share	\$ (0.05)	\$ (0.10)	\$ (0.18)	\$ (0.65)
Weighted average shares outstanding basic and diluted	15,025,522	14,456,542	15,011,345	14,377,019

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****ATRICURE, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW****(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (2,773,857)	\$ (9,407,990)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Goodwill impairment		6,812,389
Depreciation	1,095,904	1,044,518
Amortization of deferred financing costs	51,500	42,496
Write-off of deferred financing costs		102,485
Amortization of discount on long-term debt	102,602	44,657
Amortization of intangible assets	140,750	140,750
Loss on disposal of equipment		3,083
Change in allowance for doubtful accounts	(14,378)	35,933
Share-based compensation expense	1,438,980	1,971,013
<b>Changes in assets and liabilities:</b>		
Accounts receivable	(638,572)	(855,135)
Inventories	(1,247,449)	437,382
Other current assets	530,643	83,162
Accounts payable	247,703	(772,508)
Accrued liabilities	(595,912)	(720,248)
Other non-current assets and non-current liabilities	(222,084)	(163,289)
<b>Net cash used in operating activities</b>	<b>(1,884,170)</b>	<b>(1,201,302)</b>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(1,037,008)	(757,958)
Purchases of available-for-sale securities	(3,608,774)	(2,009,267)
Maturities of available-for-sale securities	5,298,491	
Change in restricted cash and cash equivalents		6,000,000
<b>Net cash provided by investing activities</b>	<b>652,709</b>	<b>3,232,775</b>
<b>Cash flows from financing activities:</b>		
Payments on debt and capital leases	(1,113,078)	(6,377,799)
Proceeds from borrowings of debt		6,500,000
Payment of debt fees	(65,597)	(123,233)
Proceeds from issuance of common stock under employee stock purchase plan	225,084	120,410
Proceeds from stock option exercises	34,754	
<b>Net cash (used in) provided by financing activities</b>	<b>(918,837)</b>	<b>119,378</b>
Effect of exchange rate changes on cash and cash equivalents	98,979	128,745
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(2,051,319)</b>	<b>2,279,596</b>
Cash and cash equivalents beginning of period	8,905,425	11,448,451
<b>Cash and cash equivalents end of period</b>	<b>\$ 6,854,106</b>	<b>\$ 13,728,047</b>



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### Supplemental cash flow information:

Cash paid for interest	\$ 236,939	\$ 161,737
Cash paid for income taxes	\$ 21,639	\$ 6,250
Non-cash investing and financing activities:		
Purchases of property and equipment in current liabilities	\$ 36,630	\$ 6,721
Warrant issued in conjunction with credit facility	\$	\$ 455,000

See accompanying notes to condensed consolidated financial statements.

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**ATRICURE, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of the Business** AtriCure, Inc. (the Company or AtriCure) was incorporated in the State of Delaware on October 31, 2000. The Company develops, manufactures and sells devices designed primarily for the surgical ablation of cardiac tissue and devices for the exclusion of the left atrial appendage. The Company sells its products to hospitals and medical centers in the United States and internationally. International sales were \$2,347,015 and \$2,552,485 during the three months ended June 30, 2010 and 2009, respectively, and \$5,248,641 and \$4,838,450 during the six months ended June 30, 2010 and 2009, respectively.

**Basis of Presentation** The accompanying interim financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). The accompanying interim financial statements are unaudited, but in the opinion of the Company's management, contain all the normal, recurring adjustments considered necessary to present fairly the financial position, results of operations and cash flows for the periods presented in conformity with generally accepted accounting principles applicable to interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been omitted or condensed. The Company believes the disclosures herein are adequate to make the information presented not misleading. Results of operations are not necessarily indicative of the results expected for the full fiscal year or for any future period.

The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the audited financial statements of the Company included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 filed with the SEC.

**Principles of Consolidation** The Condensed Consolidated Financial Statements include the accounts of the Company and AtriCure Europe, B.V., the Company's wholly-owned subsidiary incorporated in the Netherlands. All intercompany accounts and transactions have been eliminated in consolidation.

**Cash and Cash Equivalents** The Company considers highly liquid investments with maturities of three months or less at the date of acquisition as cash equivalents in the accompanying Condensed Consolidated Financial Statements.

**Short-Term Investments** The Company places its investments primarily in U.S. Government agencies and securities, corporate bonds and commercial paper. The Company classifies all investments as available-for-sale. Such investments are recorded at fair value, with unrealized gains and losses recorded as a separate component of stockholders' equity. The Company recognizes gains and losses when these securities are sold using the specific identification method.

**Revenue Recognition** The Company accounts for revenue in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 605, Revenue Recognition (ASC 605). The Company determines the timing of revenue recognition based upon factors such as passage of title, installation, payment terms and ability to return products. The Company recognizes revenue when all of the following criteria are met: (i) persuasive evidence that an arrangement exists; (ii) delivery of the products and/or services has occurred; (iii) the selling price is fixed or determinable; and (iv) collectability is reasonably assured.

Revenue is generated from the sale of the Company's surgical devices. Our surgical devices consist primarily of individual disposable handpieces and equipment generators. Our customers need the combination of the generator and the handpieces to have a functional system. The Company believes that the generator and handpiece are considered a single unit of accounting under ASC 605 because neither the generator nor handpiece have value to the customer on a standalone basis. Therefore, because the customer needs both the generator and handpiece to have a functional system, revenue is recognized upon the later of delivery of the generator or handpiece.

Pursuant to the Company's standard terms of sale, revenue is recognized when title to the goods and risk of loss transfers to customers and there are no remaining obligations that will affect the customers' final acceptance of the sale. Generally, the Company's standard terms of sale define the transfer of title and risk of loss to occur upon shipment to the respective customer. The Company generally does not maintain any post-shipment obligations to the recipients of the products. Typically, no installation, calibration or testing of this equipment is performed by the

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Company subsequent to shipment to the customer in order to render it operational.

Product revenue includes shipping and handling revenue of \$167,454 and \$163,535 for the three months ended June 30, 2010 and 2009, respectively, and \$321,217 and \$332,891 for the six months ended June 30, 2010 and 2009, respectively. Cost of freight for shipments made to customers is included in cost of revenue. Sales and other value-added taxes collected from customers and remitted to governmental authorities are excluded from product revenue. The Company sells its products primarily through a direct sales force and through AtriCure Europe, B.V. Terms of sale are generally consistent for both end-users and distributors except that payment terms are generally net 30 days for end-users and net 60 days for distributors.

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**Sales Returns and Allowances** The Company maintains a provision for sales returns and allowances to account for potential returns of defective or damaged products, products shipped in error, and price reductions given to customers. The Company estimates such provision quarterly based primarily on a specific identification basis. Increases to the provision result in a reduction of revenue.

**Allowance for Doubtful Accounts Receivable** The Company evaluates the collectability of accounts receivable in order to determine the appropriate reserve for doubtful accounts. In determining the amount of the reserve, the Company considers aging of account balances, historical credit losses, customer-specific information and other relevant factors. An increase to the allowance for doubtful accounts results in a corresponding increase in expense. The Company reviews accounts receivable and adjusts the allowance based on current circumstances and charges off uncollectible receivables against the allowance when all attempts to collect the receivable have failed.

**Inventories** Inventories are stated at the lower of cost or market using the first-in, first-out cost method ( FIFO ) and consist of raw materials, work in process, and finished goods. A reserve for inventory is estimated and recorded for excess, slow moving and obsolete inventory as well as inventory with a carrying value in excess of its net realizable value. Write-offs are recorded when a product is destroyed. The Company reviews inventory on hand at least quarterly and records provisions for excess and obsolete inventory based on several factors including current assessment of future product demand, anticipated release of new products into the market, historical experience and product expiration. The Company's industry is characterized by rapid product development and frequent new product introductions. Uncertain timing of product approvals, variability in product launch strategies, and variation in product utilization all impact the estimates related to excess and obsolete inventory.

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Raw materials	\$ 2,498,756	\$ 1,839,610
Work in process	687,614	411,738
Finished goods	2,992,222	2,801,530
Reserve for obsolescence	(189,626)	(183,170)
<b>Inventories, net</b>	<b>\$ 5,988,966</b>	<b>\$ 4,869,708</b>

**Property and Equipment** Property and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method of depreciation for financial reporting purposes and applied over the estimated useful lives of the assets. The estimated useful life by major asset category is the following: machinery and equipment is three to seven years, computer and other office equipment is three years, furniture and fixtures is three to seven years, and leasehold improvements and equipment leased under a capital lease are the shorter of their useful life or remaining lease term. Maintenance and repair costs are expensed as incurred.

Included in property and equipment are generators and other capital equipment (such as the Company's switchbox units and cryosurgical consoles) that are loaned at no cost to direct customers that use the Company's disposable products. These generators are depreciated over a three-year period, which approximates their useful lives, and such depreciation is included in cost of revenue. Depreciation related to these generators was \$318,137 and \$280,192 for the three months ended June 30, 2010 and 2009, respectively, and \$645,513 and \$533,257 for the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010 and December 31, 2009, the net carrying amount of loaned equipment included in net property and equipment in the Condensed Consolidated Balance Sheets was \$1,721,220 and \$1,756,638, respectively.

**Impairment of Long-Lived Assets (Other than Goodwill)** The Company reviews property and equipment and definite-lived intangibles for impairment using its best estimates based on reasonable and supportable assumptions and projections in accordance with FASB ASC 360, Property, Plant and Equipment (ASC 360). The Company did not recognize any impairment of long-lived assets for the six months ended June 30, 2010 and 2009.

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**Goodwill and Intangible Assets** As of December 31, 2008 the Company had \$6,812,389 in goodwill, which represented the excess of costs over the fair value of the net assets acquired in business combinations. The Company historically tested its goodwill for impairment annually during its fourth quarter, or more frequently if impairment indicators were present or changes in circumstances indicated that carrying value of the asset exceeded the estimated fair value. FASB ASC 350, Intangibles Goodwill and Other (ASC 350) requires a two-step approach to determine any potential goodwill impairment. The first step (Step 1) requires a comparison of the carrying value of the reporting unit to its fair value. Goodwill is considered potentially impaired if the carrying value of the reporting unit is greater than the estimated fair value. If potential impairment exists based upon completion of Step 1, Step 2 must be completed, which compares the implied fair value of a reporting unit's goodwill to its carrying value. Step 2 involves an analysis allocating the fair value determined in Step 1 (as if it was the purchase price in a business combination). If the calculated fair value of the goodwill resulting from this allocation is lower than the carrying value of the goodwill of the reporting unit, an impairment loss is recorded. During the three months ended March 31, 2009, the Company's market capitalization declined and was less than its recorded net book value, which indicated that a potential impairment existed. The Company recorded a full impairment loss related to its goodwill during the three months ended March 31, 2009, based on the results of its Step 1 analysis. During the second quarter of 2009, the Company performed its Step 2 analysis and concluded that the estimated charge recorded was appropriate.

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Intangible assets with determinable useful lives are amortized on a straight-line basis over the estimated periods benefited, which range from four to eight years.

**Income Taxes** Income taxes are computed using the asset and liability method in accordance with FASB ASC 740 Income Taxes (ASC 740), under which deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred taxes are measured using provisions of currently enacted tax laws. A valuation allowance against deferred tax assets is recorded when it is more likely than not that such assets will not be fully realized. Tax credits are accounted for as a reduction of income taxes in the year in which the credit originates.

The Company's estimate of the valuation allowance for deferred tax assets requires it to make significant estimates and judgments about its future operating results. The Company's ability to realize the deferred tax assets depends on its future taxable income as well as limitations on their utilization. A deferred tax asset is reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized prior to its expiration. The projections of the Company's operating results on which the establishment of a valuation allowance is based involve significant estimates regarding future demand for the Company's products, competitive conditions, product development efforts, approvals of regulatory agencies and product cost. If actual results differ from these projections, or if the Company's expectations of future results change, it may be necessary to adjust the valuation allowance.

**Net Loss Per Share** Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Since the Company has experienced net losses for all periods presented, net loss per share excludes the effect of 3,584,753 and 3,522,292 options, restricted stock and performance based shares as of June 30, 2010 and 2009, respectively, because they are anti-dilutive. Therefore the number of shares calculated for basic net loss per share is also used for the diluted net loss per share calculation.

**Accumulated Other Comprehensive (Loss) Income** Other comprehensive (loss) income consisted of the following:

	Unrealized Gains (Losses) on Short-Term Investments	Foreign Currency Translation Adjustment	Accumulated Other Comprehensive Income (Loss)
Balance as of December 31, 2009	\$ 2,685	\$ 141,605	\$ 144,290
January 1, 2010 to March 31, 2010 change	(1,452)	(89,437)	(90,889)
Balance as of March 31, 2010	1,233	52,168	53,401
April 1, 2010 to June 30, 2010 change	607	(161,074)	(160,467)
Balance as of June 30, 2010	\$ 1,840	\$ (108,906)	\$ (107,066)

**Foreign Currency Transaction Losses** The Company recorded foreign currency transaction losses of \$95,746 and \$81,869 for the three months ended June 30, 2010 and 2009, respectively, and \$159,952 and \$130,256 for the six months ended June 30, 2010 and 2009, respectively, in connection with partial settlements of its intercompany balance with its subsidiary.

**Research and Development** Research and development costs are expensed as incurred. These costs include compensation and other internal and external costs associated with the development and research related to new products or concepts, preclinical studies, clinical trials and the cost of products used in trials and tests.

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**Share-Based Compensation** The Company follows FASB ASC 718 Compensation-Stock Compensation ( ASC 718 ), to record share-based compensation for all share-based payment awards, including stock options, restricted stock, performance shares and employee stock purchases related to an employee stock purchase plan, based on estimated fair values. The Company's share-based compensation expense recognized under ASC 718 for the three months ended June 30, 2010 and 2009 was \$626,946 and \$860,280 respectively, and for the six months ended June 30, 2010 and 2009 was \$1,438,980 and \$1,971,013, respectively, on a before and after tax basis.

FASB ASC 718 requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Condensed Consolidated Statement of Operations. The expense has been reduced for estimated forfeitures. FASB ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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**ATRICURE, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The Company estimates the fair value of options on the date of grant using the Black-Scholes option-pricing model ( Black-Scholes model ). The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of highly complex and subjective variables. These variables include but are not limited to the Company's and the peer group's expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors. For non-employee options, the fair value at the date of grant is subject to adjustment at each vesting date based upon the fair value of the Company's common stock.

The Company estimates the fair value of restricted stock and performance share awards based upon the grant date closing market price of the Company's common stock. The Company's determination of fair value is affected by the Company's stock price as well as assumptions regarding the number of shares expected to be granted and, in the case of performance shares, the likelihood that the performance measures will be achieved.

The Company also has an employee stock purchase plan ( ESPP or the Plan ) which is available to all eligible employees as defined by the Plan. Under the ESPP, shares of the Company's common stock may be purchased at a discount. The Company estimates the number of shares to be purchased under the Plan and records compensation expense based upon the fair value of the stock at the beginning of the purchase period using the Black-Scholes model.

The Company has historically issued stock options to non-employee consultants as a form of compensation for services provided to the Company. The Company accounts for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50, *Equity-Based Payments to Non-Employees*. Because these options do not contain specific performance provisions, there is no measurement date of fair value until the options vest. Therefore, the fair value of the options granted and outstanding prior to their vesting date is remeasured each reporting period. During the three months ended June 30, 2010 and 2009, \$3,295 and \$8,919, respectively, of compensation expense was recorded as a result of the remeasurement of the fair value of these unvested stock options. During the six months ended June 30, 2010 and 2009, \$6,161 and \$7,097, respectively, of expense was recorded as a result of the remeasurement of the fair value of these unvested stock options.

Because the options require settlement by the Company's delivery of registered shares and because the tax withholding provisions in the awards allow the options to be partially net-cash settled, these options, when vested, are no longer eligible for equity classification and are, thus, subsequently accounted for as derivative liabilities under FASB ASC 815 until the awards are ultimately either exercised or forfeited. Accordingly, the vested nonemployee options are classified as liabilities and remeasured at fair value through earnings at each reporting period.

During the three months ended June 30, 2010 and 2009, \$27,204 and \$75,973, respectively, of expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options. During the six months ended June 30, 2010 and 2009, \$27,494 and \$51,143, respectively, of expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options.

As of June 30, 2010 and December 31, 2009, respectively, fully vested options to acquire 50,254 and 52,359 shares of common stock held by non-employee consultants remained unexercised and a liability of \$207,782 and \$180,288 was included in accrued liabilities in the Consolidated Balance Sheets as of June 30, 2010 and December 31, 2009, respectively.

In connection with the Company's \$6.5 million term loan, the Company issued a warrant to purchase shares of the Company's common stock. The warrant, which was legally detachable and separately exercisable from the debt agreement, allowed Silicon Valley Bank ( SVB ) to purchase 371,732 shares of the Company's common stock at \$1.224 per share and was exercisable for a term of ten years. The warrant was immediately exercisable and was subsequently exercised by SVB on October 6, 2009 through a net share settlement transaction in which 276,143 shares were issued. Upon issuance of the term loan and the warrant, the Company allocated the related proceeds between these two financial instruments based on their relative fair values in accordance with FASB ASC 470, *Debt*. Proceeds of \$455,000 were allocated to the warrant and recorded as additional paid-in capital, and the remaining proceeds of \$6,045,003 were recorded as the initial net carrying value of the debt.

**Use of Estimates** The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements



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and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

**Fair Value Disclosures** The fair value of the Company's financial instruments, including cash and cash equivalents, accounts receivable, short-term investments, short and long-term other assets, accounts payable, accrued expenses, other liabilities and fixed interest rate debt, approximate their fair values.

### **2. RECENT ACCOUNTING PRONOUNCEMENTS**

In October 2009, the FASB issued new guidance in ASU 985, *Software* (ASU 985), which amends the accounting and disclosure for revenue recognition. These amendments, effective for fiscal years beginning on or after June 15, 2010 (early adoption is permitted), modify the criteria for recognizing revenue in multiple element arrangements and the scope of what constitutes a non-software deliverable. The Company is currently assessing the impact on its consolidated financial position and results of operations.

In January 2010, the FASB issued new guidance in ASU 820, *Fair Value Measurements and Disclosures*, which requires reporting entities to make new disclosures about recurring or nonrecurring fair value measurements including (i) significant transfers into and out of Level 1 and Level 2 fair value measurements and (ii) information on purchases, sales, issuances and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. This new guidance is effective for interim and annual reporting

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**ATRICURE, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for interim and annual periods beginning after December 15, 2010. The Company has incorporated the additional disclosures required for Level 2 fair value measurements. The Company will adopt Level 3 disclosures beginning in the first quarter of 2011.

In February 2010, the FASB amended ASU 855, Subsequent Events Amendments to Certain Recognition and Disclosure Requirements. This amends the subtopic that requires an SEC filer to evaluate subsequent events through the date that the financial statements are issued, and no longer requires disclosure of the date through which subsequent events have been evaluated. This alleviates potential conflicts between the Subtopic 855-10 and the SEC's requirements.

**3. FAIR VALUE**

FASB ASU 820, Fair Value Measurements and Disclosures (ASU 820) defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. The valuation under this approach does not entail a significant degree of judgment.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The valuation technique for the Company's Level 2 assets is based on quoted market prices for similar assets from observable pricing sources at the reporting date.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. The fair value of the Company's Level 3 investments are estimated on the grant date using the Black-Scholes model and they are revalued at the end of each reporting period using the Black-Scholes model.

In accordance with ASC 820, the following table represents the Company's fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2010:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Total
<b>Assets:</b>				

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Money market funds	\$	\$	4,078,364	\$	\$ 4,078,364
Commercial paper			249,723		249,723
U.S. government agencies and securities		4,463,526			4,463,526
Corporate bonds		412,862			412,862
Total assets	\$	4,876,388	\$	4,328,087	\$ 9,204,475
<b>Liabilities:</b>					
Derivatives instruments	\$		\$	207,782	\$ 207,782
Total liabilities	\$		\$	207,782	\$ 207,782

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In accordance with ASC 820, the following table represents the Company's fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Total
<b>Assets:</b>				
Money market funds	\$	\$ 7,173,778	\$	\$ 7,173,778
Commercial paper		2,397,445		2,397,445
U.S. government agencies and securities	4,018,252			4,018,252
Corporate bonds	400,976			400,976
Total assets	\$ 4,419,228	\$ 9,571,223	\$	\$ 13,990,451
<b>Liabilities:</b>				
Derivatives instruments	\$	\$	\$ 180,288	\$ 180,288
Total liabilities	\$	\$	\$ 180,288	\$ 180,288

The fair value of the Level 3 liabilities is estimated using the Black-Scholes model including the following assumptions:

	As of June 30, 2010	As of December 31, 2009
Risk free interest rate	0.25% - 1.86%	0.55% - 2.94%
Expected life of option (years)	0.63 - 5.21	1.13 - 5.71
Expected volatility of stock	68.00%	61.00%
Dividend yield	0.00%	0.00%

The Company has historically issued stock options to non-employee consultants as a form of compensation for services provided to the Company. Once these non-employee options have vested, the awards no longer fall within the scope of ASC 505-50. Because the options require settlement by the Company's delivery of registered shares and because the tax withholding provisions in the awards allow the options to be partially net-cash settled, these vested options are no longer eligible for equity classification and are, thus, accounted for as derivative liabilities under FASB ASC 815 ( Derivatives and Hedging ) until the awards are ultimately either exercised or forfeited. Accordingly, the vested non-employee options are classified as liabilities and remeasured at fair value through earnings at each reporting period. In calculating the fair value of the options they are estimated on the grant date using the Black-Scholes model subject to change in stock price utilizing assumptions of risk-free interest rate, contractual life of option, expected volatility, weighted average volatility and dividend yield. Due to the lack of certain observable market quotes the Company utilizes valuation models that rely on some Level 3 inputs. Specifically, the Company's estimate of volatility is weighted 75% and 25% between the Company's implied volatility and the implied volatility of a group of comparable companies, respectively.

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	<b>Fair Value Measurements Using Significant Other Unobservable Inputs (Level 3) Derivative Instruments</b>	
	<b>June 30, 2010</b>	<b>December 31, 2009</b>
<b>Beginning Balance</b>	\$ 180,288	\$ 40,368
Total losses (realized/unrealized) included in earnings	27,494	140,620
Purchases, issuances, and settlement		(700)
<b>Ending Balance</b>	\$ 207,782	\$ 180,288
Losses included in earnings (or changes in net assets attributable to the change in unrealized losses relating to assets held at reporting date)	\$ (27,494)	\$ (140,620)

**Table of Contents****ATRICURE, INC. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****4. GOODWILL AND INTANGIBLE ASSETS**

Intangible assets with definite lives are amortized over their estimated useful lives. The following table provides a summary of the Company's intangible assets with definite lives:

	<b>Proprietary manufacturing technology</b>	<b>Non-compet agreement</b>	<b>Tradename</b>	<b>Total</b>
Net carrying amount as of December 31, 2008	\$ 344,778	\$ 82,292	\$ 142,083	\$ 569,153
Amortization	(214,000)	(12,500)	(55,000)	(281,500)
Net carrying amount as of December 31, 2009	130,778	69,792	87,083	287,653
Amortization	(107,000)	(6,250)	(27,500)	(140,750)
Net carrying amount as of June 30, 2010	\$ 23,778	\$ 63,542	\$ 59,583	\$ 146,903

Amortizable intangible assets are being amortized over eight years for a non-compet arrangement, four years for tradename usage and five years for proprietary manufacturing technology. Amortization expense related to intangible assets with definite lives was \$70,375 for each of the three month periods ended June 30, 2010 and 2009 and was \$140,750 for each of the six month periods ended June 30, 2010 and 2009.

Estimated future amortization expense related to intangible assets with definite lives is as follows:

<b>Year</b>	<b>Amortization</b>	
2010	\$ 57,528	July 1, 2010 through December 31, 2010
2011	44,583	
2012	12,500	
2013	12,500	
2014	12,500	
2015	7,292	
<b>Total</b>	<b>\$ 146,903</b>	

Goodwill represents the excess of costs over the fair value of the net assets acquired in business combinations. The Company historically tested its goodwill for impairment annually during the fourth quarter, or more frequently if impairment indicators were present or changes in circumstances indicated the carrying value of the asset exceeds the estimated fair value. FASB ASC 350 requires a two-step approach to determine any potential goodwill impairment. The first step (Step 1) requires a comparison of the carrying value of the reporting unit to the fair value of the unit. Goodwill is considered potentially impaired if the carrying value of the reporting unit is greater than the estimated fair value. If potential impairment exists based upon completion of Step 1, Step 2 is required, which compares the implied fair value of a reporting unit's goodwill to its carrying value. Step 2 involves an analysis allocating the fair value determined in Step 1 (as if it was the purchase price in a business combination). If the calculated fair value of the goodwill resulting from this allocation is lower than the carrying value of the goodwill of the reporting unit, an impairment loss is recorded.

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As a result of a reduction in the Company's market capitalization during the first quarter of 2009, the Company believed an indication of impairment existed and performed a Step 1 analysis of its goodwill as of March 31, 2009. The Step 1 process concluded that the carrying value of the Company's single reporting unit exceeded its estimated fair value.

To estimate the fair value of the reporting unit for Step 1, the Company utilized the market valuation approach. Under the market valuation approach the estimated fair value of the reporting unit is based on the Company's market capitalization using the closing market price of the Company's stock and number of shares outstanding as of March 31, 2009. The Company also considered a control premium that represents the estimated amount an investor would pay for a controlling interest in the Company. An income approach was also used to corroborate the results of the Step 1 test. The discounted cash flow method was used to measure the fair value of the Company's equity under the income approach. Determining the fair value using a discounted cash flow method includes assumptions about future market conditions and operating results. The judgments were based upon historical experience, current market trends and projected estimated future revenue and profit margins. The Company believed that these estimates and assumptions were reasonable and that different estimates and assumptions could have resulted in a different outcome. Determining the control premium to apply to the reporting unit is a subjective process that involves the use of estimates and judgments. The income approach supported the interim Step 1 test result using the market valuation approach in determining that the carrying value of the reporting unit exceeded the fair value.

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Step 2 of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of the goodwill. If the carrying amount of the Company's goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized for an amount equal to that excess. As required, the Company performed Step 2 of the goodwill impairment test during the three month period ended June 30, 2009. Based on the results of this test, the Company concluded its goodwill was fully impaired and that the estimated impairment of \$6,812,389 (which represented the cumulative impairment since inception) on a before and after tax basis was appropriately recorded as of March 31, 2009. This impairment was recorded as an increase in operating expenses, loss from operations, and net loss in the Condensed Consolidated Statement of Operations during the three months ended March 31, 2009.

The following table provides a summary of the Company's changes in the net carrying amount of goodwill:

Net carrying amount as of December 31, 2008	\$ 6,812,389
Goodwill impairment	(6,812,389)
Net carrying amount as of December 31, 2009	\$

**5. ACCRUED LIABILITIES**

Accrued liabilities consisted of the following:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Accrued commissions	\$ 1,065,947	\$ 1,251,681
Other accrued liabilities	618,078	625,773
Accrued bonus	513,723	779,949
Accrued Department of Justice settlement (current portion)	318,068	562,500
Accrued taxes	259,704	269,491
Accrued payroll and related taxes	216,745	133,887
Accrued non-employee stock compensation	207,782	180,288
Accrued vacation	176,442	175,607
<b>Total</b>	<b>\$ 3,376,489</b>	<b>\$ 3,979,176</b>

**6. INDEBTEDNESS**

On May 1, 2009, the Company and SVB entered into a Loan and Security Agreement (the "Agreement") that provides a term loan and a revolving credit facility under which the Company can borrow a maximum of \$10.0 million. The Company can borrow up to \$10.0 million under the revolving loan facility with the availability subject to a borrowing base formula. On May 1, 2009, the Company borrowed the maximum amount of \$6.5 million under the term loan. In connection with the term loan, SVB received a warrant to purchase 371,732 shares of the Company's common stock at \$1.224 per share, exercisable for a term of ten years (the "Warrant"). The Warrant was immediately exercisable and was exercised via a net share settlement exercise on October 6, 2009, resulting in the issuance of 276,143 shares of the Company's common stock. The Agreement also includes up to a \$1.0 million sublimit for stand-by letters of credit.



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Interest on the term loan accrues at a rate of 10.0% per year, and interest on the revolving loan will accrue at a fluctuating rate equal to SVB's announced prime rate of interest, subject to a floor of 4.0%, plus between 1.0% and 2.0%, depending on the Company's Adjusted Quick Ratio (as defined in the Agreement). Principal on the term loan is being paid over 36 months in equal principal payments of \$180,556 plus applicable interest. The Agreement matures on April 30, 2012 and is secured by all of the Company's assets, including intellectual property.

The Agreement contains covenants that include, among others, covenants that limit the Company's and its subsidiaries' ability to dispose of assets, enter into mergers or acquisitions, incur indebtedness, incur liens, pay dividends or make distributions on the Company's capital stock, make investments or loans, and enter into certain affiliate transactions, in each case subject to customary exceptions for a credit facility of this size and type. Additional covenants apply when the Company has outstanding borrowings under the revolving loan facility or when the Company achieves specific covenant milestones. The occurrence of an event of default could result in an increase to the applicable interest rate by 3.0%, an acceleration of all obligations under the Agreement, an obligation of the Company to repay all obligations in full, and a right by SVB to exercise all remedies available to it under the Agreement and related agreements including the Guaranty and Security Agreement. As of June 30, 2010, we were in compliance with all of the financial covenants of our credit facility.

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On November 4, 2009, effective September 30, 2009, the Company entered into a Consent, Waiver and First Loan Modification Agreement with SVB, which amended, among other things, the financial covenants in the Agreement. On March 26, 2010, the Company entered into a Waiver and Second Loan Modification Agreement with SVB, which amended, among other things, the financial covenants in the Agreement and waived a compliance violation which occurred during February 2010. On August 3, 2010, the Company entered into a debt commitment letter with SVB, which increased the Company's borrowing capacity under the revolving loan facility by expanding our total availability, eliminating the Term Loan reserve, adding a sublimit for an Export-Import Bank Loan and Security Agreement in connection with the Company's foreign accounts receivable and inventory, and added a sublimit secured by a portion of the Company's domestic inventory.

As of June 30, 2010, the Company had no borrowings under its revolving credit facility and borrowing availability of \$1,946,289. Also as of June 30, 2010, the Company had \$3,972,222 outstanding under its term loan, which includes \$2,166,667 classified as current maturities of long-term debt. The Warrant was recorded as a discount on long-term debt at its relative fair value and is being amortized over the term of the loan. For the three months ended June 30, 2010 and 2009, amortization expense related to the debt discount totaled \$48,996 and \$44,657, respectively. For the six months ended June 30, 2010 and 2009, amortization expense related to the debt discount totaled \$102,602 and \$44,657, respectively. The effective interest rate on borrowings under the term loan, including amortization of the debt discount and debt issuance costs, is 15.2%. The Company had an outstanding letter of credit of \$250,000, issued to its corporate credit card program provider, as of June 30, 2010. The letter of credit's expiration date was July 31, 2010. During July 2010, the letter of credit was renewed and expires on July 31, 2011.

As of June 30, 2010 the Company had capital leases for computer equipment that expire at various terms through 2013. The cost of the assets under lease was \$207,847. These assets are depreciated over the estimated useful life of the asset, which equals the term of the lease. Accumulated amortization on the capital leases was \$109,816 at June 30, 2010.

Maturities on long-term debt (gross of the discount on long-term debt), including capital lease obligations, are as follows:

2010	\$ 1,114,353	July 1, 2010 through December 31, 2010
2011	2,193,356	
2012	751,706	
2013	10,498	
<b>Total maturities on long-term debt</b>	<b>\$ 4,069,913</b>	

As of December 31, 2009, the Company had no borrowings under its revolving credit facility and borrowing availability of \$1,054,144. Also as of December 31, 2009, the Company had \$5,055,556 outstanding under its term loan, which included \$2,166,667 classified as current maturities of long-term debt. As of December 31, 2009 the Company had an outstanding letter of credit of \$250,000 issued to its corporate credit card program provider.

**7. COMMITMENTS AND CONTINGENCIES*****Operating Leases***

The Company leases various types of office, manufacturing and warehouse facilities and equipment under noncancelable operating leases that expire at various terms through 2014.

***Royalty Agreement***

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The Company has certain royalty agreements in place with terms that include payment of royalties based on product revenue from sales of current products. Effective January 1, 2010, royalty rates are 5% of such revenue, and one agreement includes a minimum quarterly payment of \$50,000 through 2015 and a maximum of \$2,000,000 in total royalties from 2010 through 2015. Parties to royalty agreements each have the right at any time to terminate the agreement immediately for cause. Royalty expense was \$57,890 and \$50,000 for the three months ended June 30, 2010 and 2009, respectively, and \$110,048 and \$100,000 for the six months ended June 30, 2010 and 2009.

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**(Unaudited)**

***Purchase Agreement***

On June 15, 2007 the Company entered into a purchase agreement with MicroPace Pty Ltd Inc., ( MicroPace ), which was amended in June 2008. Under the amended agreement, MicroPace produced a derivative of one of their products tailored for the cardiac surgical environment, known as the MicroPace ORLab for worldwide distribution by the Company. Pursuant to the terms of the amended agreement, in order for the Company to retain exclusive distribution rights, the Company is required to purchase a minimum of 70 units during 2008 and is required to purchase 80 units each for 2009 and 2010. As of June 30, 2010, a total of 158 units have been purchased by the Company. Units purchased in excess of yearly minimums in a year reduce future minimum purchase requirements. The Company has 72 units remaining to purchase by December 31, 2010 under the commitment in order to retain exclusive distribution rights.

***Life Support Technology, LST b.v.***

In September of 2007, multiple proceedings between the Company and Life Support Technology, LST b.v., or LST., a former distributor of AtriCure products in Europe, were settled. The settlement agreement provides for the Company to pay LST 257,360 (euros) in 16 payments of 16,085, with the final payment due January 1, 2011. If the U.S. Dollar to Euro conversion rate on any of the 16 payment due dates set forth in the agreement is less than \$1.36 to the Euro, the Company will owe LST additional compensation, up to a maximum of 28,310, which reduces over time. The Company has recorded liabilities of \$57,602 and \$109,755 as of June 30, 2010 and December 31, 2009, respectively.

***Distributor Termination***

Effective July 2, 2010, the Company terminated a distributor agreement with a European distributor. Under the terms of the agreement the Company paid the distributor 200,000 (approximately \$250,000) and is obligated to repurchase saleable disposable product inventory, which is estimated to be \$100,000. Additionally, the Company is obligated, upon appropriate assignment, to pay approximately \$100,000 for capital equipment, a majority of which is on loan at customer locations. Additionally, the Company entered into a consulting agreement with the distributor to provide ongoing consulting services through September 30, 2012. In exchange for these services, beginning October 1, 2010, the distributor will earn 50,000 (approximately \$63,000) per quarter for a total of 400,000 (approximately \$500,000). Additionally, the distributor will earn 10,000 (approximately \$12,500) per month for consulting services during the third quarter of 2010.

**Legal**

**Class Action Lawsuits**

AtriCure, Inc. and certain of its current and former officers were named as defendants in a purported securities class action lawsuit filed in the United States District Court for the Southern District of New York (Levine v. AtriCure, Inc., Case No. 06 CV 14324 (United States District Court for the Southern District of New York)). The suit alleges violations of the federal securities laws and seeks damages on behalf of purchasers of the Company's common stock during the period from our initial public offering in August 2005 through February 16, 2006. The Company filed a motion to dismiss the lawsuit for lack of subject matter jurisdiction. This motion was denied in September 2007, and a motion for reconsideration of that denial was denied in January 2009. Although the Company admitted no wrongdoing, as of December 31, 2009, the Company recorded a liability of \$2,000,000, which represented an estimate of the potential defense and/or settlement costs, of which the Company expects to recover all of that loss through an insurance claim. As such, the Company has recorded a \$2,000,000 asset within other current assets, which represents the amount considered probable of recovery from the insurance claim.

On December 12, 2008 AtriCure, Inc. and certain of its current executive officers were named in a putative class action lawsuit which is now captioned In re AtriCure, Inc. Securities Litigation, filed in the U.S. District Court for the Southern District of Ohio, Western Division. The plaintiffs allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and seek unspecified damages against AtriCure, Inc. and certain of its current executive officers. The plaintiffs allege, among other things, that the defendants issued materially false and misleading statements that failed to disclose that the Company improperly promoted certain products to physicians and caused the filing of false claims for reimbursement. In July 2009 the Company filed a motion to dismiss, and in September 2009,

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the plaintiffs filed their memorandum in opposition to the Company's motion to dismiss to which the Company responded on November 9, 2009. On March 29, 2010, the court granted in part and denied in part the Company's motion to dismiss and, in particular, dismissed the claim that the Company caused the filing of false claims for reimbursement. Although the Company admitted no wrongdoing, as of June 30, 2010, the Company recorded a liability of \$2,750,000, which represented an estimate of the potential defense and/or settlement costs, of which the Company expects to recover all of that loss through an insurance claim. As such, the Company has recorded a \$2,750,000 asset within other current assets, which represents the amount considered probable of recovery from the insurance claim.

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**Department of Justice Investigation**

On October 27, 2008, the Company received a letter from the Department of Justice ( DOJ ) informing the Company that the DOJ was conducting an investigation for potential False Claims Act ( FCA ) and common law violations relating to its surgical ablation devices. Specifically, the letter stated that the DOJ was investigating the Company's marketing practices utilized in connection with its surgical ablation system to treat atrial fibrillation ( AF ), a specific use outside the FDA's 510(k) clearance. The letter also stated that the DOJ was investigating whether the Company instructed hospitals to bill Medicare for cardiac surgical ablation using incorrect billing codes. The Company cooperated with the investigation and operated its business in the ordinary course during the investigation. As of December 31, 2009, the Company reached a tentative settlement with the DOJ to resolve the investigation and recorded a liability and charged operating expenses for a total of \$3,955,405, which represented the net present value of the proposed settlement amount to be paid to the DOJ, the relator, and relator's counsel (total payments based on the settlement inclusive of interest were estimated to be \$4,350,000, payable over five years).

On February 2, 2010, the settlement was finalized pursuant to the preliminary terms and the Company entered into a settlement agreement with the DOJ, the OIG, and the relator in the *qui tam* complaint discussed below. The settlement agreement definitively resolved all claims related to the DOJ investigation. The Company did not admit nor will it admit to any wrongdoing in connection with the settlement. As of June 30, 2010, the Company made \$525,000 in payments (including interest), and has a liability related to this settlement totaling \$3,515,677, of which \$318,068 is classified as current.

As part of the resolution, the Company also entered into a five year Corporate Integrity Agreement with the OIG. This agreement acknowledges the existence of the Company's corporate compliance program and provides for certain other compliance-related activities during the five year term of the agreement. Those activities include specific written standards, monitoring, training, education, independent review, disclosure and reporting requirements.

***Qui Tam* Complaint**

On July 10, 2009, a copy of a *qui tam* complaint against the Company was unsealed. The *qui tam* complaint, filed in the U.S. District Court for the Southern District of Texas, was originally filed by the relator in August 2007. The complaint, which was related to the DOJ investigation, alleged a cause of action under the FCA relating to the Company's alleged marketing practices in connection with its surgical cardiac ablation devices. In August 2009 the DOJ declined to intervene in the *qui tam* complaint. The *qui tam* complaint was settled in February 2010 in accordance with the DOJ settlement agreement.

The Company may from time to time become a party to additional legal proceedings.

**8. INCOME TAX PROVISION**

The Company files federal, state, and foreign income tax returns in jurisdictions with varying statutes of limitations. Income taxes are computed using the asset and liability method in accordance with FASB ASC 740 under which deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred taxes are measured using provisions of currently enacted tax laws. A valuation allowance against deferred tax assets is recorded when it is more likely than not that such assets will not be fully realized. Tax credits are accounted for as a reduction of income taxes in the year in which the credit originates. The Company does not expect any significant unrecognized tax benefits to arise over the next twelve months.

The Company's provision for income taxes for continuing operations in interim periods is computed by applying its estimated annual effective rate against its loss before income tax (expense) benefit for the period. In addition, non-recurring or discrete items are recorded during the period in which they occur. The effective tax rate for the three months ended June 30, 2010 and 2009 was (0.01%) and 0.76%, respectively. The effective tax rate for the six months ended June 30, 2010 and 2009 was 0.06% and 0.45%, respectively.

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The Company currently has not had to accrue interest and penalties related to unrecognized income tax benefits. However when or if the situation occurs, the Company will recognize interest and penalties within the income tax expense (benefit) line in the accompanying Condensed Consolidated Statements of Operations and within the related tax liability in the Condensed Consolidated Balance Sheets.

### **9. EQUITY COMPENSATION PLANS**

The Company has several share-based incentive plans: the 2001 Stock Option Plan (the 2001 Plan ), the 2005 Equity Incentive Plan (the 2005 Plan ) and the 2008 Employee Stock Purchase Plan (the ESPP ).

#### ***2001 Plan and 2005 Plan***

The 2001 Plan is no longer used for granting incentives. Under the 2005 Plan, the Board of Directors may grant incentive stock options to employees and any parent or subsidiary s employees, and may grant nonstatutory stock options, restricted stock, stock

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appreciation rights, performance units or performance shares to employees, directors and consultants of the Company and any parent or subsidiary's employees, directors and consultants. The administrator (currently the Compensation Committee of the Board of Directors) has the power to determine the terms of any awards, including the exercise price of options, the number of shares subject to each award, the exercisability of the awards and the form of consideration.

Options granted under the 2001 Plan and the 2005 Plan generally expire ten years from the date of grant. Options granted from the 2001 Plan are generally exercisable beginning one year from the date of grant in cumulative yearly amounts of 25% of the shares granted. Options granted from the 2005 Plan generally vest over four years at a rate of 25% on the first anniversary date of the grant and ratably each month thereafter. Certain options granted were exercisable at the time of the grant and the underlying unvested shares are subject to the Company's repurchase rights as stated in the applicable plan agreement.

As of June 30, 2010, 5,303,131 shares of common stock had been reserved for issuance under the 2005 Plan. The shares authorized for issuance under the 2005 Plan include: (a) shares reserved but unissued under the 2001 Plan as of August 10, 2005, (b) shares returned to the 2001 Plan as the result of termination of options or the repurchase of shares issued under such plan, and (c) annual increases in the number of shares available for issuance on the first day of each year equal to the lesser of:

3.25% of the outstanding shares of common stock on the first day of the fiscal year;

825,000 shares; or

an amount the Company's Board of Directors may determine.

On January 1, 2010, an additional 498,982 shares were authorized for issuance under the 2005 Equity Incentive Plan representing 3.25% of the outstanding shares on that date. As of June 30, 2010 there were 691,005 shares available for future grants under the plans.

Activity under the Plans was as follows:

<b>Stock Options</b>	<b>Number of Shares Outstanding</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at January 1, 2010	2,533,977	\$ 8.20		
Granted	433,500	\$ 5.51		
Cancelled or forfeited	(59,825)	\$ 9.79		
Exercised	(29,888)	\$ 1.16		
Outstanding at June 30, 2010	2,877,764	\$ 7.84	6.29	\$ 3,730,002
Vested and expected to vest	2,833,879	\$ 7.86	6.25	\$ 3,676,096



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Exercisable at June 30, 2010	2,002,633	\$ 8.15	5.21	\$ 2,869,024
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	Number of Shares Outstanding	Weighted Average Grant Date Fair Value
<b>Restricted Stock</b>		
Outstanding at January 1, 2010	360,909	\$ 3.26
Granted	136,100	\$ 5.49
Forfeited	(3,500)	\$ 2.15
Released	(39,770)	\$ 2.50
<b>Outstanding at June 30, 2010</b>	<b>453,739</b>	<b>\$ 4.01</b>

The total intrinsic value of options exercised during the three and six month periods ended June 30, 2010 was \$114,880 and \$142,100, respectively, and as a result of the Company's tax position, no tax benefit was recognized related to the stock option exercises. There were no options exercised during the three and six month periods ended June 30, 2009. For the six months ended June 30, 2010, \$34,754 in cash proceeds was included in the Company's Condensed Consolidated Statements of Cash Flows as a result of the exercise of stock options. The total fair value of restricted stock vested during the three months ended June 30, 2010 and 2009 was \$174,250 and \$862,000, respectively. The total fair value of restricted stock vested during the six months ended June 30, 2010 and 2009 was \$211,834 and \$1,947,470, respectively.

The exercise price per share of each option is equal to the fair market value of the underlying share on the date of grant. The Company issues registered shares of common stock to satisfy stock option exercises and restricted stock grants.

The Company recognized expense related to stock options and restricted stock for the three months ended June 30, 2010 and 2009 of \$506,478 and \$759,996, respectively, and for the six months ended June 30, 2010 and 2009 of \$1,184,345 and \$1,797,645,

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**ATRICURE, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

respectively. As of June 30, 2010 there was \$4,724,114 of unrecognized compensation costs related to non-vested share-based compensation arrangements (\$3,223,164 relating to stock options and \$1,500,950 relating to restricted stock). This cost is expected to be recognized over a weighted average period of 2.6 years for stock options and 1.7 years for restricted stock.

The Company issued performance shares to certain employees and consultants to incent and reward them for the achievement of specified performance over various service periods. The participants received awards for a specified number of shares of the Company's common stock at the beginning of the award period, which entitles the participants to the shares at the end of the award period, if achievement of the specified metrics and service requirements occurs. As of June 30, 2010 the Company has the potential to issue 253,250 shares of common stock based upon each participant meeting all of the specified metrics. In accordance with FASB ASC 718, the Company estimates the number of shares to be granted based upon the probability that the performance metric and service period will be achieved. The fair value of the estimated award, based on the market value of the Company's stock on the date of award, is expensed over the award period. During the three months ended June 30, 2010 and 2009, the Company recognized expense related to the performance shares of \$73,155 and \$74,044, respectively. During the six months ended June 30, 2010 and 2009, the Company recognized expense related to the performance shares of \$163,919 and \$124,552, respectively. The probability of meeting the specified metrics is reviewed quarterly. As of June 30, 2010, there was \$146,621 of unrecognized compensation costs related to non-vested share-based compensation arrangements associated with these performance shares. This cost is expected to be recognized over a weighted-average period of 0.6 years.

***Employee Stock Purchase Plan (ESPP)***

During the second quarter of 2008, the Company established its 2008 Employee Stock Purchase Plan ( ESPP ) which is available to eligible employees as defined in the plan. Under the ESPP, shares of the Company's common stock may be purchased at a discount (currently 15%) of the lesser of the closing price of the Company's common stock on the first trading day or the last trading day of the offering period. The offering period (currently six months) and the offering price are subject to change. Participants may not purchase more than \$25,000 of the Company's common stock in a calendar year and effective January 1, 2009, may not purchase more than 1,500 shares during an offering period. Beginning on January 1, 2009 and on the first day of each fiscal year thereafter during the term of the ESPP, the number of shares available for sale under the ESPP shall be increased by the lesser of (i) two percent (2%) of the Company's outstanding shares of common stock as of the close of business on the last business day of the prior calendar year, not to exceed 600,000 shares, or (ii) a lesser amount determined by the Board of Directors. At June 30, 2010, there were 673,301 shares available for future issuance under the ESPP, including 307,066 additional shares approved for issuance by the Company's Board of Directors effective January 1, 2010. Share-based compensation expense with respect to the ESPP was \$44,018 and \$17,319 for the three months ended June 30, 2010 and 2009, respectively, and \$84,555 and \$41,719 for the six months ended June 30, 2010 and 2009, respectively.

**Table of Contents****ATRICURE, INC. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Valuation and Expense Information Under FASB ASC 718**

The following table summarizes share-based compensation expense related to employee share-based compensation under FASB ASC 715 for the three and six month periods ended June 30, 2010 and 2009. This expense was allocated as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Cost of revenue	\$ 32,643	\$ 65,377	\$ 72,754	\$ 171,596
Research and development expenses	129,711	214,093	231,853	524,943
Selling, general and administrative expenses	461,297	571,889	1,128,212	1,267,377
Total share-based compensation expense related to employees	\$ 623,651	\$ 851,359	\$ 1,432,819	\$ 1,963,916

In calculating compensation expense, the fair value of the options is estimated on the grant date using the Black-Scholes model including the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Risk free interest rate	2.48%	2.52%	2.48%-2.88%	2.42%-2.52%
Expected life of option (years)	6.00-6.25	6.00-6.25	6.00-6.25	6.00-6.25
Expected volatility of stock	71.00%	62.00%	69.00%-71.00%	53.50%-62.00%
Weighted-average volatility	71.00%	62.00%	69.40%	60.16%
Dividend yield	0.00%	0.00%	0.00%	0.00%

The Company's estimate of volatility is based on the Company's trading history and other companies in the industry. For grants made after December 31, 2009, the Company's estimate of volatility was weighted 75% and 25% between the Company's trading history and other companies in the industry, respectively. The risk-free interest rate assumption is based upon the U.S. treasury yield curve at the time of grant for the expected option life. The simplified method is utilized in determining the expected life of the option.

The fair value of restricted stock awards is based on the market value of the Company's stock on the date of the awards.

Based on the assumptions noted above, the weighted average estimated fair value per share of the stock options and restricted stock granted for the respective periods was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Stock options	\$ 3.32	\$ 1.51	\$ 3.56	\$ 1.36
Restricted stock	\$ 5.15	\$ 2.58	\$ 5.49	\$ 1.62

**Non-Employee Stock Compensation**

The Company has issued nonstatutory common stock options to consultants to purchase shares of common stock as a form of compensation for services provided to the Company. Such options vest over a service period ranging from immediately to four years. After January 1, 2006, all

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stock options to non-employee consultants have a four year vesting period and vest at a rate of 25% on the first anniversary date of the grant and ratably each month thereafter.

The fair value at the date of grant, which is subject to adjustment at each vesting date, was determined using the Black-Scholes model. There were no non-employee stock options granted during the three and six month periods ended June 30, 2010 and 2009. The values attributable to the non-vested portion of the non-employee stock options have been amortized over the service period on a graded vesting method and the vested portion of these stock options was remeasured at each vesting date.

**Table of Contents****ATRICURE, INC. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

The Company accounts for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50, *Equity-Based Payments to Non-Employees*. Because these options do not contain specific performance provisions, there is no measurement date of fair value until the options vest. Therefore, the fair value of the options granted and outstanding prior to their vesting date is remeasured each reporting period. Stock compensation expense with respect to unvested non-employee stock options totaled \$3,295 and \$8,919, respectively, for the three months ended June 30, 2010 and 2009 and for the six months ended June 30, 2010 and 2009 of \$6,161 and \$7,097, respectively.

Once these non-employee stock options have vested, the awards no longer fall within the scope of ASC 505-50. Because the stock options require settlement by the Company's delivery of registered shares and because the tax withholding provisions in the awards allow the stock options to be partially net-cash settled, these vested stock options are no longer eligible for equity classification and are, thus, accounted for as derivative liabilities under FASB ASC 815 ( *Derivatives and Hedging* ) until the stock options are ultimately either exercised or forfeited. Accordingly, the vested non-employee stock options are classified as liabilities and remeasured at fair value through earnings at each reporting period. During the three months ended June 30, 2010 and 2009, \$27,204 and \$75,973, respectively, of expense was recorded as a result of the remeasurement of the fair value of these stock options. During the six months ended June 30, 2010 and 2009, \$27,494 and \$51,143, respectively, of expense was recorded as a result of the remeasurement of the fair value of these stock options. As of June 30, 2010 and December 31, 2009, respectively, fully vested stock options to acquire 50,254 and 52,359 shares of common stock held by non-employee consultants remained unexercised and a liability of \$207,782 and \$180,288 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of June 30, 2010 and December 31, 2009, respectively.

**10. SEGMENT AND GEOGRAPHIC INFORMATION**

The Company considers reporting segments in accordance with FASB ASC 280, *Segment Reporting* . The Company develops, manufactures, and sells devices designed primarily for the surgical ablation of cardiac tissue. These devices are developed and marketed to a broad base of medical centers in the United States and internationally. Management considers all such sales to be part of a single operating segment.

Geographic revenue was as follows:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
United States	\$ 11,845,297	\$ 11,225,465	\$ 22,895,471	\$ 22,613,403
International	2,347,015	2,552,485	5,248,641	4,838,450
<b>Total</b>	<b>\$ 14,192,312</b>	<b>\$ 13,777,950</b>	<b>\$ 28,144,112</b>	<b>\$ 27,451,853</b>

Substantially all of the Company's long-lived assets are located in the United States.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto contained in Item 1 of Part I of this Form 10-Q and our audited financial statements and notes thereto as of and for the year ended December 31, 2009 included in our Form 10-K filed with the Securities and Exchange Commission ( SEC ) to provide an understanding of our results of operations, financial condition and cash flows.

### **Forward-Looking Statements**

This Form 10-Q, including the sections titled Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors, contains forward-looking statements regarding our future performance. All forward-looking information is inherently uncertain and actual results may differ materially from assumptions, estimates or expectations reflected or contained in the forward-looking statements as a result of various factors, including those set forth under Risk Factors and elsewhere in this quarterly report on Form 10-Q, and in our annual report on Form 10-K for the year ended December 31, 2009. Forward-looking statements convey our current expectations or forecasts of future events. All statements contained in this Form 10-Q other than statements of historical fact are forward-looking statements. Forward-looking statements include statements regarding our future financial position, business strategy, budgets, projected costs, plans and objectives of management for future operations. The words may, continue, estimate, intend, plan, will, believe, project, expect, anticipate and other expressions may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking. With respect to the forward-looking statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements speak only as of the date of this Form 10-Q. Unless required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect new information or future events or otherwise.

### **Overview**

We are a medical device company and a leader in developing, manufacturing and selling innovative cardiac surgical ablation systems designed to create precise lesions, or scars, in cardiac, or heart, tissue and devices designed to exclude the left atrial appendage. We have three primary product lines. Our primary product line, which accounts for a majority of our revenue, is our Isolator® Synergy bipolar ablation clamp system, or Isolator system, and related radiofrequency, or RF, ablation devices. Additionally, we offer a cryoablation product line, which features reusable and disposable cryoablation probes. During the fourth quarter of 2009 we initiated a European launch of our AtriClip Gillinov-Cosgrove Left Atrial Appendage System, or AtriClip system, which is designed to safely and effectively exclude the left atrial appendage. During June 2010, we received FDA clearance and commercially released the AtriClip system in the United States.

Cardiothoracic surgeons have adopted our Isolator system to treat atrial fibrillation, or AF, in an estimated 70,000 patients since January 2003 and we believe that we are currently the market leader in the surgical treatment of AF. Our products are utilized by cardiothoracic surgeons in open-heart, or open, concomitant surgical procedures and also during sole-therapy minimally invasive cardiac ablation procedures. During an open procedure, the surgeon ablates cardiac tissue and/or treats the left atrial appendage, secondary, or concomitant, to a primary cardiac procedure such as a valve or coronary bypass. Medical journals have described the adoption by leading cardiothoracic surgeons of our Isolator system as a treatment alternative during open-heart surgical procedures to create lesions in cardiac tissue to block the abnormal electrical impulses that cause AF, a rapid, irregular quivering of the upper chambers of the heart. Additionally, leading cardiothoracic surgeons and publications in medical journals have described our Isolator system as a standard treatment alternative for AF patients who may be candidates for sole-therapy minimally invasive surgical procedures. To date, none of our products have been approved or cleared by the Food and Drug Administration, or FDA, for the treatment of AF or stroke reduction. We anticipate that substantially all of our revenue for the foreseeable future will relate to products we currently sell or are in the process of developing, which surgeons generally use to ablate cardiac tissue for the treatment of AF or for the exclusion of the left atrial appendage.

### **Recent Developments**

During May 2010 our clinical trial, known as DEEP AF, was conditionally approved by the FDA. DEEP AF is a feasibility trial designed to evaluate the safety and effectiveness of our minimally invasive products with catheter mapping and ablation technologies for the treatment of patients with persistent and long-standing persistent AF. The 30-patient trial will be conducted at six U.S. medical centers.

During June 2010 we received FDA clearance for the AtriClip system for the occlusion of the left atrial appendage, under direct visualization, in conjunction with other open cardiac surgical procedures. We initiated a limited commercial release of the AtriClip system in June and anticipate a full commercial release during the third quarter of 2010.



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During June 2010, we also received FDA clearance for our Linear Multifunctional Pen for cardiac ablation, temporary cardiac pacing, sensing and stimulation during the diagnosis of cardiac arrhythmias during surgery. We plan to commercially release this product in the U.S. during the fourth quarter of 2010 and internationally in the first quarter of 2011. The Linear Multifunctional Pen is a disposable RF device that enables surgeons to evaluate cardiac arrhythmias, perform temporary pacing, stimulation, sensing and ablate cardiac tissue with the same device. We believe surgeons will adopt this device in combination with our Isolator clamps.

We currently anticipate filing with the FDA the final module in support of a Premarket Approval (PMA) related to our ABLATE trial, during the first quarter of 2011.

As disclosed in our Form 10-K for the year ended December 31, 2009, we modified the indication for our Isolator Synergy clamps, a modification we believed did not require us to seek additional 510(k) clearance. At the time our Isolator clamps received 510(k) clearance for the ablation of cardiac tissue, through our internal and external regulatory review process, we determined that a new 510(k) was not needed for our Isolator Synergy clamps to change their intended use from the ablation of soft tissue to the ablation of cardiac tissue. The FDA reviewed our decision and indicated its belief that a 510(k) was required to be filed for us to market our Isolator Synergy clamps for cardiac tissue ablation instead of soft tissue ablation. Based on communications with the FDA, during April 2010 we submitted a 510(k) in support of a cardiac tissue ablation clearance for our Isolator Synergy system and we voluntarily re-labeled our Isolator Synergy clamps to reflect a soft tissue ablation indication. During July 2010, we received a communication from the FDA which included a request for additional information regarding our 510(k) filing. We are in the process of gathering information to respond to the FDA.

Effective July 2, 2010, we terminated our distributor agreement with a European distributor. Under the terms of the agreement we paid the distributor 200,000 (approximately \$250,000) and are obligated to repurchase saleable disposable product inventory, which we estimate to be \$100,000. Additionally, we are obligated, upon appropriate assignment, to pay approximately \$100,000 for capital equipment, a majority of which is on loan at customer locations. Additionally, we entered into a consulting agreement with the distributor to provide ongoing consulting services through September 30, 2012. In exchange for these services, beginning October 1, 2010, the distributor will earn 50,000 (approximately \$63,000) per quarter for a total of 400,000 (approximately \$500,000). Additionally, the distributor will earn 10,000 (approximately \$12,500) per month for consulting services for each month during the third quarter of 2010. We believe that selling directly in this market will allow us to better penetrate this market and expand the adoption of our products.

Also disclosed in our Form 10-K for the year ended December 31, 2009 was the potentially substantial impact on our business of the recently-enacted Patient Protection and Affordable Care Act (the Patient Act ) and other healthcare reform legislation being contemplated by Congress and certain state legislatures. While we are currently evaluating the effects of the Patient Act on our business, the impact on the health care industry is extensive and includes, among other things, having the federal government assume a larger role in the health care system, expanding healthcare coverage of U.S. citizens and mandating basic healthcare benefits. The Patient Act also imposes a new excise tax on medical device manufacturers of 2.3% of medical device sales in the United States that will result in an increase in our expenses. The Patient Act will be phased in over a number of years and could reduce our revenues, will increase our expenses, and could require us to revise the way in which we conduct business or put us at risk for loss of business.



**Table of Contents****Results of Operations****Three months ended June 30, 2010 compared to three months ended June 30, 2009**

The following table sets forth, for the periods indicated, our results of operations expressed as dollar amounts and as percentages of total revenue:

	Three Months Ended June 30, 2010		2009	
	Amount	% of Revenues (dollars in thousands)	Amount	% of Revenues
Revenue	\$ 14,192	100.0%	\$ 13,778	100.0%
Cost of revenue	2,964	20.9%	3,108	22.6%
Gross profit	11,229	79.1%	10,670	77.4%
Operating expenses:				
Research and development expenses	2,422	17.1%	3,138	22.8%
Selling, general and administrative expenses	9,239	65.1%	8,565	62.1%
Total operating expenses	11,661	82.2%	11,703	84.9%
Loss from operations	(433)	(3.1%)	(1,033)	(7.5%)
Other income (expense):				
Interest expense	(215)	(1.5%)	(278)	(2.0%)
Interest income	6	0.1%	15	0.1%
Other	(123)	(0.9%)	(158)	(1.2%)
Other expense	(332)	(2.3%)	(421)	(3.1%)
Loss before income tax benefit	(764)	(5.4%)	(1,454)	(10.6%)
Income tax benefit			(11)	(0.1%)
Net loss	\$ (765)	(5.4%)	\$ (1,443)	(10.5%)

**Revenue.** Total revenue increased 3.0%, from \$13.8 million for the three months ended June 30, 2009 to \$14.2 million for the three months ended June 30, 2010. The increase in revenue was primarily due to a \$0.6 million increase in sales to U.S. customers, driven primarily by sales of our recently released Cryo1 device, driven primarily by market share gains. This increase was partially offset by a \$0.2 million reduction in sales to international customers, which was primarily attributed to a \$0.4 million decrease in revenue in a European market that we converted from a third party distributor to a direct selling model effective July 2, 2010. On a constant currency basis, consolidated revenue grew 3.7% as compared to the reported 3.0% and international revenue declined 4.0% as compared to the reported 8.0%.

**Cost of revenue and gross margin.** Cost of revenue decreased \$0.1 million, from \$3.1 million for the three months ended June 30, 2009 to \$3.0 million for the three months ended June 30, 2010. As a percentage of revenue, cost of revenue decreased from 22.6% to 20.9% for the three months ended June 30, 2009 and 2010, respectively. Gross margin for the three months ended June 30, 2010 and 2009 was 79.1% and 77.4%, respectively. The decrease in cost of revenue and the improvement in gross margin was primarily due to a reduction in product costs, primarily associated with increased manufacturing efficiencies, and an increased mix of sales from customers in the United States, which generally carry a higher average selling price and corresponding gross margin than sales to international customers. These were partially offset by an increased mix of revenue from new products, such as Cryo1, which has a lower gross margin than our disposable RF products and a reduction in average selling prices for sales to international customers, due to general economic conditions, reimbursement, and competitor pricing.

**Research and development expenses.** Research and development expenses decreased \$0.7 million, from \$3.1 million for the three months ended June 30, 2009 to \$2.4 million for the three months ended June 30, 2010. As a percentage of revenue, research and development expenses decreased from 22.8% for the three months ended June 30, 2009 to 17.1% for the three months ended June 30, 2010. The decrease was primarily attributable to:

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\$0.6 million reduction in expenditures related to product development initiatives driven primarily by the timing and nature of products under development in the second quarter of 2010 as compared to the second quarter of 2009;

\$0.2 million decrease in spending related to clinical trial enrollment related expenditures, due to completion of enrollment in ABLATE and EXCLUDE during earlier periods; and

\$0.2 million increase in clinical and regulatory consulting expenditures associated with increased clinical and regulatory activities and increased use of a third party consultant in support of clinical activities.

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We anticipate research and development expenses to increase in terms of aggregate dollar spend during the third and fourth quarter of 2010 in support of our product development initiatives as well as an anticipated increase in clinical trial enrollment expenditures associated with our DEEP AF clinical trial and increased clinical and regulatory activities in support of our final ABLATE PMA module submission.

**Selling, general and administrative expenses.** Selling, general and administrative expenses increased \$0.7 million or 7.9%, from \$8.6 million for the three months ended June 30, 2009 to \$9.2 million for the three months ended June 30, 2010. The increase was primarily attributable to a \$0.7 million increase in headcount related selling expenses driven by an increase in average worldwide sales and marketing headcount of 10 individuals to support our growth initiatives.

**Net interest expense.** Net interest expense decreased \$0.1 million to \$0.2 million for the three months ended June 30, 2010. The decrease was primarily due to an increase in interest incurred associated with our May 2009 term loan borrowing under our credit facility and related amortization of the discount on long-term debt for the warrant issued in May 2009 in conjunction with our credit facility. These increases were offset by net interest expense for the three months ended June 30, 2009, including a write-off of debt fees of \$0.1 million associated with the termination of a credit facility.

**Other expense.** Other expense consists primarily of foreign currency transaction gains/losses and non-employee option expense/ income related to the fair market value change for fully vested options outstanding for consultants, which are accounted for as free standing derivatives. For each of the three months ended June 30, 2010 and 2009, other expense included \$0.1 million related to foreign currency transaction losses associated with partial settlements of intercompany balances. Other expense for the three months ended June 30, 2010 and 2009 included expense of approximately \$27,000 and \$76,000, respectively, associated with an increase in value of certain non-employee stock options.

**Six months ended June 30, 2010 compared to six months ended June 30, 2009**

The following table sets forth, for the periods indicated, our results of operations expressed as dollar amounts and as percentages of total revenue:

	Six Months Ended June 30,		2009	
	2010	% of Revenues	2009	% of Revenues
	Amount	(dollars in thousands)	Amount	
Revenue	\$ 28,144	100.0%	\$ 27,452	100.0%
Cost of revenue	6,236	22.2%	6,053	22.0%
Gross profit	21,908	77.8%	21,399	78.0%
Operating expenses:				
Research and development expenses	5,080	18.1%	6,055	22.1%
Selling, general and administrative expenses	18,951	67.3%	17,497	63.7%
Goodwill impairment			6,812	24.8%
Total operating expenses	24,031	85.4%	30,364	110.6%
Loss from operations	(2,123)	(7.5%)	(8,965)	(32.7%)
Other income (expense):				
Interest expense	(478)	(1.7%)	(339)	(1.2%)
Interest income	13		36	0.1%
Other	(187)	(0.7%)	(182)	(0.7%)
Other expense	(652)	(2.3%)	(485)	(1.8%)
Loss before income tax benefit	(2,776)	(9.9%)	(9,450)	(34.4%)
Income tax benefit	(2)		(42)	(0.1%)
Net loss	\$ (2,774)	(9.9%)	\$ (9,408)	(34.3%)

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**Revenue.** Total revenue increased 2.5%, from \$27.5 million for the six months ended June 30, 2009 to \$28.1 million for the six months ended June 30, 2010. The increase in revenue was primarily due to a \$0.3 million increase in sales to U.S. customers, driven primarily by sales of our recently released Cryo1 device of \$1.5 million, partially offset by a reduction in revenues from our RF ablation devices. Sales to international customers increased \$0.4 million to \$5.2 million. The increase in sales to international customers was primarily due to increased market penetration, driven by increased sales and marketing activities, and sales from new products. These increases were partially offset by a \$0.4 million decrease in revenue in a European market that we converted from a third party distributor to a direct selling model effective July 2, 2010. On a constant currency basis, consolidated revenue was consistent with reported revenue and international revenue increased 9.0% as compared to the reported 8.5%.

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**Cost of revenue and gross margin.** Cost of revenue increased slightly from \$6.1 million for the six months ended June 30, 2009 to \$6.2 million for the six months ended June 30, 2010. As a percentage of revenue, cost of revenue increased slightly from 22.0% to 22.2% for the six months ended June 30, 2009 and 2010, respectively. Gross margin for the six months ended June 30, 2010 and 2009 were 77.8% and 78.0%, respectively. The increase in cost of revenue was primarily due to an increase in revenue. The reduction in gross margin was primarily due to an increased mix of revenue from the sale of new products, such as Cryo1, which has a lower gross margin than our disposable RF products, an increased mix of sales from international customers, which generally carry a lower gross margin than sales to U.S. customers, and a reduction in average selling prices to international customers, due to general economic conditions, reimbursement, and competitor pricing. These reductions were partially offset by a reduction in product costs, primarily due to increased manufacturing efficiencies.

**Research and development expenses.** Research and development expenses decreased \$1.0 million, from \$6.1 million for the six months ended June 30, 2009 to \$5.1 million for the six months ended June 30, 2010. As a percentage of revenue, research and development expenses decreased from 22.1% for the six months ended June 30, 2009 to 18.1% for the six months ended June 30, 2010. The decrease was primarily attributable to:

\$1.1 million decrease in expenditures related to product development initiatives driven primarily by the timing and nature of products under development this year as compared to last year;

\$0.3 million decrease in share based compensation due primarily to payment of bonuses during 2009 in restricted shares;

\$0.4 million decrease in spending related to clinical trial enrollment related expenditures, due to completion of enrollment in ABLATE and EXCLUDE during earlier periods; and

\$0.9 million increase in clinical and regulatory consulting expenditures associated with increased clinical and regulatory activities and increased use of a third party consultant in support of clinical activities.

We anticipate research and development expenses to increase during the second half of 2010 in support of our product development initiatives as well as an anticipated increase in clinical trial enrollment expenditures associated with our DEEP AF clinical trial and increased clinical and regulatory activities in support of our ABLATE PMA module submission.

**Selling, general and administrative expenses.** Selling, general and administrative expenses increased \$1.5 million or 8.3%, from \$17.5 million for the six months ended June 30, 2009 to \$19.0 million for the six months ended June 30, 2010. The increase was primarily attributable to a \$1.3 million increase in headcount related selling expenses driven by an increase in average worldwide sales and marketing headcount of 10 individuals to support our growth initiatives.

**Goodwill impairment.** As a result of a reduction in our market capitalization during the first quarter of 2009, we believed an indication of impairment existed and we performed an interim Step 1 analysis of our goodwill as of March 31, 2009. The Step 1 process concluded that the carrying value of our goodwill exceeded the estimated fair value. We were unable to complete Step 2 prior to the issuance of our financial statements for the three month period ended March 31, 2009; however a full impairment loss was determined as probable and reasonably estimated based upon the completion of Step 1 and correspondingly, we recognized a full impairment loss of \$6.8 million during the three month period ended March 31, 2009.

**Net interest expense.** Net interest expense increased \$0.2 million to \$0.5 million for the six months ended June 30, 2010. The increase was primarily due to an increase in interest paid and an increase in average debt outstanding, due primarily to our May 2009 term loan borrowing under our credit facility and related amortization of the discount on long-term debt for the warrant issued in May 2009 in conjunction with our credit facility. These increases were partially offset by a second quarter 2009 write-off of debt fees of \$0.1 million associated with the termination of an existing credit facility.

**Other expense.** Other expense consists primarily of foreign currency transaction gains/losses and non-employee option expense/ income related to the fair market value change for fully vested options outstanding for consultants, which are accounted for as free standing derivatives. For each of the six months ended June 30, 2010 and 2009, other expense included approximately \$160,000 and \$130,000, respectively related to foreign currency transaction losses associated with partial settlements of intercompany balances. Other expense for the six months ended

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June 30, 2010 and 2009 included expense of approximately \$27,000 and \$51,000, respectively, associated with an increase in value of certain non-employee stock options.

### **Liquidity and Capital Resources**

As of June 30, 2010, we had cash, cash equivalents and short-term investments of \$12.0 million and we had borrowing capacity of approximately \$1.9 million under our revolving credit facility. During August 2010, we obtained a signed commitment letter to modify our credit facility. The modification results in an increase to our borrowing capacity of approximately \$5.5 million, resulting in total availability of approximately \$7.5 million. We had net working capital of \$17.2 million and an accumulated deficit of \$96.7 million as of June 30, 2010.

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**Cash flows used in operating activities.** Net cash used in operating activities for the six months ended June 30, 2010 was \$1.9 million. The primary uses of cash were as follows:

The net loss of \$2.8 million, offset by \$2.8 million of non-cash expenses, which included \$1.1 million in depreciation and \$1.4 million in stock-based compensation.

A net use of cash related to changes in operating assets and liabilities of \$1.9 million due primarily to the following:

an increase in accounts receivable of \$0.6 million, due primarily to an increase in sales during the latter half of the second quarter of 2010 as compared to the latter half of the second quarter of 2009;

an increase in inventory of \$1.2 million due primarily to a build-up of inventory levels in support of new products and anticipated revenue growth and to return to more normalized inventory levels from an unusually low level at the end of 2009;

a decrease in other current assets of \$0.5 million due primarily to collection of a \$0.4 million receivable related to value added taxes; and

a decrease in accrued and other liabilities of \$0.8 million primarily due to an initial \$0.5 million payment to the Department of Justice associated with our settlement of an investigation and the payment of bonuses and related taxes earned during 2009 of \$1.0 million.

**Cash flows used in investing activities.** Net cash used in investing activities was \$0.7 million for the six months ended June 30, 2010. The primary uses of cash were as follows:

A use of cash of \$1.0 million related to the purchase of equipment, which consisted primarily of loans of our generators (i.e. our ablation and sensing unit) to our customers; and

Net proceeds from the net change in investment maturities and purchases of \$1.7 million. Net redemptions in investments were to partially fund cash needed for operations, purchases of equipment, and debt repayments.

**Cash flows used in financing activities.** For the six months ended June 30, 2010, net cash used in financing activities was \$0.9 million, which was primarily due to the repayment of debt of \$1.1 million on our outstanding term loan. The term loan requires monthly principal repayment of \$0.2 million through April 2012.

**Credit facility.** On May 1, 2009, we entered into a Loan and Security Agreement (the "Agreement") with Silicon Valley Bank ("SVB") that provides a term loan and a revolving credit facility under which we can borrow a maximum of \$10.0 million. We have borrowed the maximum amount of \$6.5 million under the term loan. We can borrow up to \$10.0 million under the revolving loan facility with the availability subject to a borrowing base formula. The Agreement also includes up to a \$1.0 million sublimit for stand-by letters of credit. The Agreement matures on April 30, 2012 and is secured by all of our assets, including intellectual property.

The Agreement contains covenants that include, among others, covenants that limit the Company's and its subsidiaries' ability to dispose of assets, enter into mergers or acquisitions, incur indebtedness, incur liens, pay dividends or make distributions on the Company's capital stock, make investments or loans, and enter into certain affiliate transactions, in each case subject to customary exceptions for a credit facility of this size and type. Additional covenants apply when the Company has outstanding borrowings under the revolving loan facility or when the Company achieves specific covenant milestones. The occurrence of an event of default could result in an increase to the applicable interest rate by 3.0%, an acceleration of all obligations under the Agreement, an obligation of the Company to repay all obligations in full, and a right by

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SVB to exercise all remedies available to it under the Agreement and related agreements including the Guaranty and Security Agreement. A default event could also impact our ability to seek financing from other lenders. As of June 30, 2010, we were in compliance with all of the financial covenants of our credit facility.

Interest on the term loan accrues at a rate of 10.0% per year, and interest on the revolving loan will accrue at a fluctuating rate equal to SVB's announced prime rate of interest, subject to a floor of 4.0%, plus between 1.0% and 2.0%, depending on our Adjusted Quick Ratio (as defined in the Agreement). Principal on the term loan will be amortized over 36 months of equal principal payments of approximately \$181,000, plus applicable interest. In addition, in connection with the term loan under the Agreement, SVB received a warrant to purchase 371,732 shares of our common stock at \$1.224 per share, exercisable for a term of ten years. On October 6, 2009 the Warrant was exercised via a net share settlement and 276,143 shares were issued.

On November 4, 2009 and effective September 30, 2009, we entered into a Consent, Waiver and First Loan Modification Agreement with SVB, which amended, among other things, the financial covenants in the Agreement. On March 26, 2010, we entered into a Waiver and Second Loan Modification Agreement with SVB, which amended, among other things, the financial covenants in the Agreement and waived a compliance violation which occurred during February 2010.



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On August 3, 2010, we entered into a debt commitment letter with SVB, which increases our borrowing capacity under the revolving loan facility by expanding our total availability, eliminating the Term Loan reserve, adding a sublimit for an Export-Import Bank Loan and Security Agreement in connection with our foreign accounts receivable and inventory, and added a sublimit secured by a portion of our domestic inventory.

As of June 30, 2010, we had no borrowings under our revolving credit facility and borrowing availability of \$1.9 million. Also as of June 30, 2010, we had \$4.0 million outstanding under our term loan, which includes \$2.2 million classified as current maturities of long-term debt. The Warrant was recorded as discount on long-term debt at its fair value and is being amortized over the term of the loan. For the three and six month periods ended June 30, 2010, amortization expense related to the debt discount totaled approximately \$49,000 and \$103,000, respectively. The effective interest rate on borrowings under the term loan, including amortization of the debt discount and debt issuance costs, is 15.2%. As of June 30, 2010, we had an outstanding letter of credit of \$250,000 issued to our corporate credit card program provider which expired on July 31, 2010 and was automatically renewed for twelve months.

**Uses of liquidity and capital resources.** Our future capital requirements depend on a number of factors, including possible acquisitions and joint ventures, the rate of market acceptance of our current and future products, the resources we devote to developing and supporting our products, future expenses to expand and support our sales and marketing efforts, costs relating to changes in regulatory policies or laws that affect our operations and costs of filing, costs associated with clinical trials and securing regulatory approval for new products, and costs associated with prosecuting, defending and enforcing our intellectual property rights. Global economic turmoil may adversely impact our revenue, access to the capital markets or future demand for our products.

We believe that our current cash, cash equivalents and short-term investments, along with the cash we expect to generate or use for operations or access via our credit facility, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. This includes debt service of approximately \$0.2 million per month plus interest on our outstanding term loan, totaling \$2.3 million over the next twelve months, along with payments under our settlement agreement with the DOJ and relator of \$0.4 million over the next twelve months, and payments under the distributor termination agreement and consulting agreements of approximately \$0.7 million over the next twelve months. If these sources of cash are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or obtain a revised or additional credit facility. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights senior to those associated with our common stock and could contain covenants that would restrict our operations. Additional financing may not be available at all, or in amounts or terms acceptable to us. If we are unable to obtain this additional financing, we may be required to reduce the scope of our planned research and development, clinical activities and selling and marketing efforts.

### **Off-Balance-Sheet Arrangements**

As of June 30, 2010, we had operating lease agreements not recorded on the Condensed Consolidated Balance Sheet. Operating leases are utilized in the normal course of business.

### **Seasonality**

During the first quarter, we have historically experienced an increase in our operating expenses and operating loss due to higher selling, general and administrative expenses related primarily to our participation in and attendance at large industry events. During the third quarter, we typically experience a decline in revenues that we attribute primarily to the elective nature of the procedures in which our products are used, which we believe arises from fewer people choosing to undergo elective procedures during the summer months.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ). The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses, and disclosures of contingent assets and liabilities at the date of the financial statements. On a periodic basis, we evaluate our estimates, including those related to sales returns and allowances, accounts receivable, inventories and share-based compensation. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from those estimates under different assumptions or conditions. Our Annual Report on Form 10-K for the fiscal year ending December 31, 2009 includes additional information about the Company, our operations, our financial position, our critical accounting policies and accounting estimates and should be read in conjunction with this Quarterly Report.



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### **Recent Accounting Pronouncements**

Please see Note 2 in the Notes to the Condensed Consolidated Financial Statements for a discussion of recent accounting pronouncements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

As of June 30, 2010, there were no material changes to the information provided under Item 7A-Quantitative and Qualitative Disclosures About Market Risk in the Company's Form 10-K for the year ended December 31, 2009.

### **Item 4T. Controls and Procedures Disclosure Controls and Procedures**

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13(a)-15(e) and 15(d)-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), as of the end of the period covered by this report. Our management, including the Chief Executive Officer and Chief Financial Officer, supervised and participated in the evaluation. Based on the evaluation, we concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective in providing reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's forms and rules, and the material information relating to the Company is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Control systems, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that control objectives are met. Because of inherent limitations in all control systems, no evaluation of controls can provide assurance that all control issues and instances of fraud, if any, within a company will be detected. Additionally, controls can be circumvented by individuals, by collusion of two or more people, or by management override. Over time, controls can become inadequate because of changes in conditions or the degree of compliance may deteriorate. Further, the design of any system of controls is based in part upon assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all future conditions. Because of the inherent limitations in any cost-effective control system, misstatements due to errors or fraud may occur and not be detected.

### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information with respect to legal proceedings can be found under the heading "Commitments and Contingencies" in Note 7 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this quarterly report on Form 10-Q, and is incorporated herein by reference.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, careful consideration should be given to the factors discussed in Part I, Item 1A. Risk Factors in our Form 10-K for the year ended December 31, 2009, all of which could materially affect our business, financial condition or future results. The risks described 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 adversely affect our business, financial condition and/or operating results. There have been no material changes with respect to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Reserved**

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Rule 13a-14(a) Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Rule 13a-14(a) Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350 by the Chief Executive Officer, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 U.S.C. Section 1350 by the Chief Financial Officer, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURES**

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

AtriCure, Inc.  
(REGISTRANT)

Date: August 10, 2010

/s/ David J. Drachman  
**David J. Drachman**  
**President and Chief Executive Officer**

**(Principal Executive Officer)**

Date: August 10, 2010

/s/ Julie A. Piton  
**Julie A. Piton**  
**Vice President, Finance and Administration and Chief Financial Officer**

**(Principal Financial and Accounting Officer)**

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