

THORATEC CORP  
Form 10-Q  
November 04, 2010

**Table of Contents**

**U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(Mark one)

**Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the quarterly period ended October 2, 2010**

or

**Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**COMMISSION FILE NUMBER: 000-49798**

**THORATEC CORPORATION**

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

**California**

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

**94-2340464**

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

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

**94588**

**(Zip Code)**

**(925) 847-8600**

**(Registrant's telephone number, including area code)**

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

As of October 22, 2010, the registrant had 58,470,009 shares of common stock outstanding.

**THORATEC CORPORATION  
TABLE OF CONTENTS**

<u>Part I. Financial Information</u>	
<u>Item 1. Unaudited Condensed Consolidated Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets as of October 2, 2010 and January 2, 2010</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 2, 2010 and October 3, 2009</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 2, 2010 and October 3, 2009</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	38
<u>Item 4. Controls and Procedures</u>	39
<u>Part II. Other Information</u>	
<u>Item 1A. Risk Factors</u>	41
<u>Item 2. Unregistered Sale of Equity Securities and Use of Proceeds</u>	41
<u>Item 5. Other Information</u>	41
<u>Item 6. Exhibits</u>	42
<u>Signatures</u>	43
Exhibits	
<u>EX-2.1</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	

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

CentriMag is a registered trademark of Levitronix LLC.

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

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 50,709	\$ 27,787
Short-term available-for-sale investments	337,853	279,174
Receivables, net of allowances of \$1,242 and \$322, respectively	50,003	48,058
Inventories	57,267	44,635
Deferred tax assets	12,567	12,261
Prepaid expenses and other assets	5,063	4,831
Prepaid and other income taxes	12,380	1,234
Assets held for sale	59,880	63,798
 Total current assets	 585,722	 481,778
Property, plant and equipment, net	37,678	37,115
Goodwill	95,015	95,015
Purchased intangible assets, net	90,964	96,876
Long-term available-for-sale investments	21,578	24,634
Other long-term assets	4,041	12,465
 Total Assets	 \$ 834,998	 \$ 747,883
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 15,819	\$ 6,221
Accrued compensation	17,362	17,417
Other accrued liabilities	13,775	12,469
Senior subordinated convertible notes	136,057	
Liabilities related to assets held for sale	11,824	12,377
 Total current liabilities	 194,837	 48,484
Senior subordinated convertible notes		131,929
Long-term deferred tax liability	26,580	31,720
Other	7,849	10,622
 Total Liabilities	 229,266	 222,755
Shareholders equity:		
Common shares: no par, authorized 100,000; issued and outstanding 58,469 and 57,043 as of October 2, 2010 and January 2, 2010,		

respectively

Additional paid-in capital	599,673	557,418
Retained earnings (accumulated deficit)	9,208	(30,321)
Accumulated other comprehensive loss:		
Unrealized loss on investments	(1,239)	(648)
Cumulative translation adjustments	(1,910)	(1,321)
Total accumulated other comprehensive loss	(3,149)	(1,969)
Total Shareholders' Equity	605,732	525,128
Total Liabilities and Shareholders' Equity	\$ 834,998	\$ 747,883

See notes to unaudited condensed consolidated financial statements.

**Table of Contents**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October</b>	<b>October</b>	<b>October</b>	<b>October 3,</b>
	<b>2,</b>	<b>3,</b>	<b>2,</b>	<b>2009</b>
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Product sales	\$ 90,996	\$ 65,114	\$ 285,366	\$ 198,965
Cost of product sales	28,621	19,976	90,771	67,027
Gross profit	62,375	45,138	194,595	131,938
Operating expenses:				
Selling, general and administrative	21,104	18,283	64,010	62,625
Research and development	12,332	10,605	44,135	31,705
Amortization of purchased intangible assets	2,446	2,359	7,326	7,441
Total operating expenses	35,882	31,247	115,471	101,771
Income from operations	26,493	13,891	79,124	30,167
Other income and (expense):				
Interest expense and other	(3,125)	(3,261)	(9,280)	(9,167)
Interest income and other	1,362	7,060	4,261	9,304
Impairment on investment	(11)		(2,057)	
Income before income taxes	24,719	17,690	72,048	30,304
Income tax expense	(9,239)	(5,914)	(25,667)	(9,472)
Net income from continuing operations	15,480	11,776	46,381	20,832
Net income (loss) from discontinued operations (net of tax)	(1,183)	1	(3,697)	(1,595)
Net income	\$ 14,297	\$ 11,777	\$ 42,684	\$ 19,237
Net income (loss) per share Basic:				
Continuing operations	\$ 0.26	\$ 0.21	\$ 0.80	\$ 0.37
Discontinued operations	(0.02)		(0.06)	(0.03)
Net income	\$ 0.24	\$ 0.21	\$ 0.74	\$ 0.34
Net income (loss) per share Diluted:				
Continuing operations	\$ 0.26	\$ 0.20	\$ 0.78	\$ 0.36
Discontinued operations	(0.02)		(0.06)	(0.03)
Net income	\$ 0.24	\$ 0.20	\$ 0.72	\$ 0.33

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

Basic	58,138	56,045	57,473	55,787
Diluted	66,612	57,368	66,216	57,135

See notes to unaudited condensed consolidated financial statements.

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

**Table of Contents**

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

	<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>
<b>Cash flows from continuing operating activities:</b>		
Net income from continuing operations	\$ 46,381	\$ 20,832
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	12,309	13,162
Investment premium amortization, net	3,795	2,099
Loss on extinguishment of senior subordinated convertible notes	99	
Non-cash expenses, net	687	1,836
Non-cash interest expense	7,152	5,816
Mark-to-market adjustment on HeartWare International Inc. ( HeartWare ) conversion option		(1,786)
Fair value conversion option upon termination of HeartWare merger agreement		(3,454)
Impairment on investment	2,057	
Tax benefit related to stock options	10,343	2,885
Share-based compensation expense	9,624	7,935
Excess tax benefits from share-based compensation	(9,458)	(2,397)
Loss on disposal of assets	529	146
Change in net deferred tax liability	(4,027)	(3,528)
Changes in assets and liabilities:		
Receivables	(3,080)	(4,754)
Inventories	(15,939)	(13,464)
Prepaid expenses and other assets	(277)	(5,539)
Accounts payable and other liabilities	15,028	1,717
Prepaid and other income taxes, net	(13,851)	1,607
Net cash provided by continuing operating activities	61,372	23,113
<b>Cash flows from continuing investing activities:</b>		
Purchases of available-for-sale investments	(398,874)	(224,817)
Sales of available-for-sale investments	306,523	97,577
Maturities of available-for-sale investments	32,090	44,773
Loan collections	2,756	
Restricted cash and cash equivalents		(16,000)
HeartWare loan receivable		(4,000)
Purchases of patents	(1,414)	
Purchases of property, plant and equipment	(2,848)	(7,590)
Net cash used in continuing investing activities	(61,767)	(110,057)
<b>Cash flows from continuing financing activities:</b>		



Edgar Filing: THORATEC CORP - Form 10-Q

Excess tax benefits from share-based compensation	9,458	2,397
Proceeds from stock option exercises	22,035	6,598
Proceeds from stock issued under employee stock purchase plan	1,884	1,628
Repurchase and retirement of common shares	(4,698)	(3,255)
Extinguishment of senior subordinated convertible notes	(5,358)	
Net cash provided by continuing financing activities	23,321	7,368
Effect of exchange rate changes on cash and cash equivalents	(4)	(207)
Net increase (decrease) in cash and cash equivalents from continuing operations	22,922	(79,783)
Cash and cash equivalents from continuing operations at beginning of period	27,787	108,388
Cash and cash equivalents from continuing operations at end of period	\$ 50,709	\$ 28,605
<b>Cash flows from discontinued operations:</b>		
Net cash provided by operating activities	\$ 2,944	\$ 2,821
Net cash used in investing activities	(2,488)	(2,091)
Net increase in cash from discontinued operations	456	730
Bank overdraft from discontinued operations at beginning of period	(1,326)	(1,335)
Bank overdraft from discontinued operations at end of period	\$ (870)	\$ (605)
<b>Supplemental disclosure of consolidated cash flow information:</b>		
Cash paid for taxes	\$ 30,494	\$ 7,834
Cash paid for interest	\$ 1,707	\$ 1,707
<b>Supplemental disclosure of consolidated non-cash investing and financing activities:</b>		
Transfers of equipment from inventory	\$ 3,493	\$ 1,732
Purchases of property, plant and equipment through accounts payable and accrued liabilities	\$ 221	\$ 1,682

See notes to unaudited condensed consolidated financial statements.

Table of Contents

**THORATEC CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

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

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

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

The financial information presented herein includes continuing operations, unless otherwise stated. On April 25, 2010, our board of directors made a decision to sell our wholly-owned subsidiary, International Technidyne Corporation ( ITC ) and expects to complete this sale within the next nine months. As such, as of the second quarter of 2010, ITC met the conditions in Financial Accounting Standards Board ( FASB ) Codification ( ASC ) 360, *Property, Plant and Equipment*, to be classified as an asset held for sale, and we have elected to present ITC in this manner for all periods presented, as described in Note 15, *Assets Held for Sale*. On November 4, 2010 we sold ITC, as described in Note 17, *Subsequent Event*.

*Revenue Recognition and Product Warranty*

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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October</b>	<b>October</b>	<b>October</b>	<b>October</b>
	<b>2,</b>	<b>3,</b>	<b>2,</b>	<b>3,</b>
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(in thousands)</b>			
Balance at beginning of period	\$ 1,747	\$ 1,196	\$ 1,706	\$ 554
Accruals for warranties issued	2,765	994	4,696	2,894
Settlements made	(1,395)	(488)	(3,285)	(1,746)
Balance at end of period	\$ 3,117	\$ 1,702	\$ 3,117	\$ 1,702



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

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

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

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

**3. Cash and Cash Equivalents**

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

**4. Investments**

Our investment portfolio is comprised of short-term and long-term investments. Investments classified as short-term available-for-sale consist primarily of municipal bonds, corporate bonds, commercial paper and variable demand notes. All investments mature within two years or less from the date of purchase. Investments with maturities beyond one year may be classified as short-term, if they are available and intended for use in current operations, based on their highly liquid nature or due to the frequency with which the interest rate is reset. Investments classified as long-term available-for-sale consist of auction rate securities, whose underlying assets are student loans. In addition, certain of our long-term investments associated with the deferred compensation plan are classified as trading securities and as of October 2, 2010 consists primarily of mutual fund investments.

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

As of October 2, 2010, we had unrealized gains before tax from our investment in municipal bonds and corporate bonds of \$1.1 million and unrealized losses before tax from our auction rate securities of \$3.1 million.



**Table of Contents**

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

	<b>Amortized cost</b>	<b>Gross unrealized gains (losses) (in thousands)</b>	<b>Fair value</b>
<b>October 2, 2010:</b>			
Short-term investments:			
Municipal bonds	\$ 265,935	\$ 840	\$ 266,775
Variable demand notes	53,930		53,930
Corporate bonds	13,905	247	14,152
Commercial paper	2,996		2,996
Total	\$ 336,766	\$ 1,087	\$ 337,853
Long-term investments:			
Auction rate securities	\$ 24,700	\$ (3,122)	\$ 21,578
<b>January 2, 2010:</b>			
Short-term investments:			
Municipal bonds	\$ 196,650	\$ 1,526	\$ 198,176
Variable demand notes	66,865		66,865
Corporate bonds	13,785	348	14,133
Total	\$ 277,300	\$ 1,874	\$ 279,174
Long-term investments:			
Auction rate securities	\$ 27,700	\$ (3,066)	\$ 24,634

As of October 2, 2010 we owned approximately \$24.7 million face amount of auction rate securities classified as long-term. The assets underlying these investments are student loans backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically every seven to thirty-five days. Beginning in February of 2008, these auctions began to fail. The principal amount of these auction rate securities will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption, or they are paid at maturity.

As of October 2, 2010 we recorded an estimated cumulative unrealized loss of \$3.1 million (\$1.9 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive loss within shareholders' equity. In addition, our management reviews impairments and credit losses associated with its investments, including auction rate securities, to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of any other-than-temporary impairment event. We (i) do not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; (ii) intend to hold the investment to recovery and, based on a more-likely-than-not probability assessment, will not be required to sell the security before recovery; and (iii) deem that it is not probable that we will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the

impairment was charged to other comprehensive loss. Our auction rate securities are classified as long-term valued at \$21.6 million using significant unobservable inputs. In the third quarter of 2010 we liquidated \$3.0 million of our auction rate securities at par value through a successful auction.

**Table of Contents**

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

The aggregate value of our corporate owned life insurance policy and mutual fund investments included in our deferred compensation plan as of October 2, 2010 and January 2, 2010 were as follows:

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Deferred compensation plan	\$ 3,187	\$ 2,436

The investments associated with the deferred compensation plan is included in Other long-term assets on our condensed consolidated balance sheets at the cash surrender value of our corporate owned life insurance policies and the fair value of the mutual fund investments. The realized gain before tax from the change in the cash surrender value and the fair value of mutual fund investments for the three months and nine months ended October 2, 2010 of approximately \$0.3 million and \$0.2 million, respectively, is included in Interest income and other.

**5. Fair Value Measurements**

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

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

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

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

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

*Assets and Liabilities That Are Measured at Fair Value on a Recurring Basis*

ASC 820 principally applies to financial assets and liabilities which include short-term investments, auction rate securities, foreign exchange instruments, and certain of our deferred compensation plan assets. These items are marked-to-market at each reporting period. The information in the following paragraphs and tables primarily addresses matters relative to these financial assets and liabilities.



**Table of Contents**

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

	<b>October 2, 2010</b>				
	<b>Assets and liabilities at carrying value</b>	<b>Total fair value</b>	<b>Quoted prices in active markets for identical assets (Level 1) (in thousands)</b>	<b>Significant other observable inputs (Level 2)</b>	<b>Significant unobservable inputs (Level 3)</b>
<b>Assets</b>					
Short-term investments:					
Municipal bonds	\$ 266,775	\$ 266,775	\$	\$ 266,775	\$
Variable demand notes	53,930	53,930		53,930	
Corporate bonds	14,152	14,152		14,152	
Commercial paper	2,996	2,996		2,996	
Long-term investments auction rate securities	21,578	21,578			21,578
Other long-term assets deferred compensation plan	2,420	2,420		2,420	
<b>Liabilities</b>					
Other accrued liabilities mark-to-market on foreign exchange instruments (Note 6)	266	266		266	
<b>January 2, 2010</b>					
	<b>Assets and liabilities at carrying value</b>	<b>Total fair value</b>	<b>Quoted prices in active markets for identical assets (Level 1) (in thousands)</b>	<b>Significant other observable inputs (Level 2)</b>	<b>Significant unobservable inputs (Level 3)</b>
<b>Assets</b>					
Short-term investments:					
Municipal bonds	\$ 198,176	\$ 198,176	\$	\$ 198,176	\$
Variable demand notes	66,865	66,865		66,865	
Corporate bonds	14,133	14,133		14,133	
Prepaid expenses and other assets mark- to- market on foreign exchange instruments (Note 6)	8	8		8	
	24,634	24,634			24,634

Long-term investments	auction			
rate securities				
Other long-term assets	deferred			
compensation plan		2,436	2,436	2,436
<i>Valuation Techniques</i>				

Financial assets are considered Level 2 when their fair values are determined using inputs that are observable in the market or can be derived principally from or corroborated by observable market data such as pricing for similar securities, recently executed transactions, cash flow models with yield curves, and benchmark securities. Our Level 2 financial assets include short-term investments and certain of our deferred compensation plan securities. In addition, Level 2 financial instruments are valued using standard calculations and models that use readily observable market data as their basis.

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies, or similar techniques, and at least one significant model assumption or input is unobservable. Level 3 financial assets include certain investment securities, which include the auction rate securities for which there is limited market activity such that the determination of fair value requires significant judgment or estimation. As of October 2, 2010, these securities were valued primarily using broker pricing models that incorporate transaction details such as contractual terms, maturity, timing and amount of expected future cash flows, as well as assumptions about liquidity and credit valuation adjustments of market place participants. For the auction rate securities, inputs consist of the fair value of the auction rate securities and the present value of future cash flows are estimated by discounting future principal and interest payments over a five-year period.

**Table of Contents**

We review the fair value hierarchy classification on a quarterly basis. Changes in the ability to observe valuation inputs may result in a reclassification of levels of certain securities within the fair value hierarchy. We recognize transfers into and out of levels within the fair value hierarchy at the end of the fiscal quarter in which the actual event or change in circumstances that caused the transfer occurs. There were no significant transfers between Level 1 and Level 2 during the three and nine months ended October 2, 2010 or October 3, 2009. When a determination is made to classify an asset or liability within Level 3, the determination is based upon the significance of the unobservable inputs to the overall fair value measurement. The following table provides a reconciliation of the beginning and ending balances for the assets and liabilities measured at fair value using significant unobservable inputs (Level 3):

	<b>Auction Rate Securities (in thousands)</b>
Balance at January 2, 2010	\$ 24,634
Unrealized holding loss on auction rate securities, included in other comprehensive income	(688)
Balance as of April 3, 2010	\$ 23,946
Unrealized holding gain on auction rate securities, included in other comprehensive income	220
Balance as of July 3, 2010	\$ 24,166
Settlement at par	(3,000)
Unrealized holding gain on auction rate securities, included in other comprehensive income	412
Balance as of October 2, 2010	\$ 21,578

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

*Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis*

Non-financial assets such as goodwill, intangible assets, and property, plant, and equipment are measured at fair value when there is an indicator of impairment and recorded at fair value only when an impairment is recognized. There were no indicators of impairment as of October 2, 2010. Non-financial assets such as purchased intangibles acquired during the nine months ended October 2, 2010, are measured at fair value using Level 3 inputs, which include discounted cash flow methodologies, or similar techniques, when there is limited market activity and the determination of fair value requires significant judgment or estimation. For a detailed discussion, see Note 9,

*Goodwill and Purchased Intangible Assets.**Financial Instruments Disclosed at Fair Value*

Senior subordinated convertible notes measured at fair value on a recurring basis using Level 2 inputs include quoted prices of identical or similar liabilities and are measured at a fair value of \$272.9 million and \$205.4 million, as of October 2, 2010 and January 2, 2010, respectively. The senior subordinated convertible notes were reclassified to current liabilities during the second quarter of 2010 due to a redemption feature which may require us to repurchase all or a portion of the senior subordinated convertible notes as early as May 16, 2011. For a detailed discussion, see Note 10 Senior Subordinated Convertible Notes.

**Table of Contents****6. Foreign Exchange Instruments**

We utilize foreign currency forward exchange contracts and options to mitigate future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions (primarily assets and liabilities on our U.K. subsidiary's consolidated balance sheet). We do not use derivative financial instruments for speculative or trading purposes. We routinely hedge our exposure to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. We perform periodic evaluations of the relative credit standings of these financial institutions and limit the amount of credit exposure with any one institution. If a financial counterparty to any of our hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency forward contract, we may experience material financial losses.

The notional amount of foreign currency contracts with a maximum maturity of four months, which do not qualify for hedge accounting, were as follows:

	<b>Notional Amounts</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands)</b>	
Purchases	\$	\$ 8,816
Sales	15,503	13,900

Effective January 3, 2010, we changed our functional currency for our U.K subsidiary from U.K pounds to euros. This change did not have a material impact on our condensed consolidated financial statements; however, the change did impact our foreign currency hedging contracts. As of October 2, 2010, we owned forward contracts to sell euros to U.S. dollars with a notional value of \$8.0 million, to sell U.S. dollars to euro with a notional value of \$3.6 million and to sell U.K. pounds to euros with a notional value of £0.6 million, as compared to October 3, 2009, when we owned forward contracts to sell euros to U.S dollars with a notional value of \$9.6 million and to purchase U.K. pounds from U.S. dollars with a notional value of £5.5 million. As of October 2, 2010, our forward contracts had an average exchange rate of one U.S. dollar to 1.34796 euros and one U.K. pound to 1.15048 euros. The fair value of these contracts was \$0.3 million and is included in Other accrued liabilities in our condensed consolidated balance sheets.

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands)</b>			
Foreign currency exchange (loss) gain on foreign currency contracts	\$ (188)	\$ (803)	\$ 558	\$ 132
Foreign currency exchange (loss) gain on foreign currency translation adjustments	(78)	1,042	(704)	(406)

**7. Inventories**

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

<b>October 2, 2010</b>	<b>January 2, 2010</b>
<b>(in thousands)</b>	

Edgar Filing: THORATEC CORP - Form 10-Q

Finished goods	\$ 13,141	\$ 12,920
Work in process	12,532	7,350
Raw materials	31,594	24,365
Total	\$ 57,267	\$ 44,635

**Table of Contents****8. Property, Plant and Equipment, net**

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Land, building and improvements	\$ 18,478	\$ 18,134
Equipment and capitalized software	39,922	38,281
Furniture and leasehold improvements	21,511	20,655
Subtotal	79,911	77,070
Less accumulated depreciation	(42,233)	(39,955)
Total	\$ 37,678	\$ 37,115

**9. Goodwill and Purchased Intangible Assets**

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

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

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

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

	<b>October 2, 2010</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization (in thousands)</b>	<b>Net Carrying Amount</b>
Patents and trademarks	\$ 40,832	\$ (30,408)	\$ 10,424
Core technology	37,180	(17,015)	20,165
Developed technology	121,805	(61,430)	60,375
Total purchased intangible assets	\$ 199,817	\$ (108,853)	\$ 90,964
	<b>January 2, 2010</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization (in thousands)</b>	<b>Net Carrying Amount</b>
Patents and trademarks	\$ 39,418	\$ (29,625)	\$ 9,793
Core technology	37,180	(15,558)	21,622
Developed technology	121,805	(56,344)	65,461
Total purchased intangible assets	\$ 198,403	\$ (101,527)	\$ 96,876

Amortization expense related to purchased intangible assets for both the three months ended October 2, 2010 and October 3, 2009 was \$2.4 million. Amortization expense related to purchased intangible assets for the nine months ended October 2, 2010 and October 3, 2009 was \$7.3 million and \$7.4 million, respectively. Our amortization expense is expected to be approximately \$9.7 million in 2010, declining to \$8.7 million by 2014. This decline in amortization expense is due to certain intangibles being fully amortized. Patents and trademarks have useful lives ranging from eight to ten years, and core and developed technology assets have useful lives ranging from zero to eleven years.

**Table of Contents****10. Senior Subordinated Convertible Notes**

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

The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Beginning on May 16, 2011, the original issue discount will accrue daily at a rate of 2.375% per year on a semi-annual bond equivalent basis and, on the maturity date, a holder will receive \$1,000 per note. As a result, the aggregate principal amount of the outstanding notes at maturity will be \$243.4 million.

Holders of the senior subordinated convertible notes may convert their convertible notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on October 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of our common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, we may, at our option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes. As of October 2, 2010, 4,045 bonds of the 247,427 bonds originally issued had been submitted to be converted and we have elected to pay cash in lieu of shares for these bonds.

Holders may require us to repurchase all or a portion of their senior subordinated convertible notes on each of May 16, 2011, 2014, 2019, 2024 and 2029 at a repurchase price equal to 100% of the issue price, plus accrued original issue discount, if any. Based on this redemption feature, we reclassified the net carrying amount of the senior subordinated convertible notes to current liabilities during the second quarter of 2010.

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

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

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



		<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
		<b>October</b>	<b>October 3,</b>	<b>October</b>	<b>October 3,</b>
		<b>2,</b>	<b>2009</b>	<b>2, 2010</b>	<b>2009</b>
		<b>2010</b>			
		<b>(in thousands)</b>			
Interest expense	cash component	\$ 840	\$ 853	\$ 2,540	\$ 2,559
Interest expense	non-cash component	2,283	2,099	6,634	6,125
		14			

---

**Table of Contents**

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Senior subordinated convertible notes		
Principal amount	\$ 141,400	\$ 143,750
Unamortized discount	(5,343)	(11,821)
Net carrying amount	\$ 136,057	\$ 131,929
Equity component, net of income tax benefit	\$ 25,325	\$ 28,462

We may redeem either in whole or in part any of the senior subordinated convertible notes at any time beginning May 16, 2011, by giving the holders at least 30 days notice, at a redemption price equal to the sum of the issue price and the accrued original issue discount. If the holders converted the senior subordinated convertible notes into shares of our stock as of October 2, 2010, the as -converted value would be \$266.2 million, based on our stock price of \$37.12 per share on October 1, 2010, which amount exceeds the original value of the bonds outstanding, or \$141.4 million, by \$124.8 million. This as-converted value is \$22.8 million more than the \$243.4 million face amount of the outstanding bonds at maturity in 2034.

The aggregate fair value of the senior subordinated convertible notes at October 2, 2010 was \$272.9 million.

**11. Comprehensive Income**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands)</b>			
Net income from continuing operations	\$ 15,480	\$ 11,776	\$ 46,381	\$ 20,832
Unrealized gains (losses) on investments (net of taxes of \$92 and \$112 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$252 and \$1,643 for the nine months ended October 2, 2010 and October 3, 2009, respectively)	116	168	(591)	2,465
Foreign currency translation adjustments	1,157	(405)	(589)	871
Comprehensive income from continuing operations	16,753	11,539	45,201	24,168
Comprehensive income (loss) from discontinued operations	(1,183)	1	(3,697)	(1,595)
Comprehensive income	\$ 15,570	\$ 11,540	\$ 41,504	\$ 22,573

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

**12. Share-Based Compensation**

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

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

**Table of Contents**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands)</b>			
Cost of product sales	\$ 322	\$ 234	\$ 947	\$ 789
Selling, general and administrative	1,858	1,609	6,074	5,153
Research and development	791	594	2,603	1,993
Total share-based compensation expense before taxes	2,971	2,437	9,624	7,935
Tax benefit for share-based compensation expense	948	1,096	3,747	3,054
Total share-based compensation continuing operations (net of taxes)	\$ 2,023	\$ 1,341	\$ 5,877	\$ 4,881
Total share-based compensation discontinued operations (net of taxes)	\$ 751	\$ 657	\$ 1,524	\$ 1,770

As of October 2, 2010 and October 3, 2009, share-based compensation expense from continuing operations of \$0.3 million and \$0.3 million, respectively, was capitalized to inventory. As of both October 2, 2010 and October 3, 2009, share-based compensation expense from discontinued operations of \$0.2 million, was capitalized to inventory.

We receive a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the fair market value of the options at the date of exercise over the exercise prices of the options. Our unaudited condensed consolidated statements of cash flows presentation reports the excess tax benefits (i.e., windfall only for tax deductions in excess of the share-based compensation expense recognized) as financing cash flows of \$9.5 million and \$2.4 million for the nine months ended October 2, 2010 and October 3, 2009, respectively.

Cash proceeds from the exercise of stock options were \$22.0 million and \$6.6 million for the nine months ended October 2, 2010 and October 3, 2009, respectively. Cash proceeds from our employee stock purchase plan were \$1.9 million and \$1.6 million for the nine months ended October 2, 2010 and October 3, 2009, respectively. The Company purchased \$4.7 million and \$3.3 million of restricted stock from employees for payment of income tax withholding due upon vesting for the nine months ended October 2, 2010 and October 3, 2009, respectively.

**Equity Plan**

In April 2006, the Board of Directors approved the 2006 Incentive Stock Plan ( 2006 Plan ) and in May 2006 the 2006 Plan was approved by our shareholders. In May 2006 and April 2008 the 2006 Plan was amended by the Board of Directors and in May 2008 the 2006 Plan as amended was approved by our shareholders. In May 2008 and March 2010, the 2006 Plan was further amended by the Board of Directors and approved by our shareholders in May 2008 and May 2010, respectively. The 2006 Plan allows us to grant to our employees, directors and consultants up to a total of 8.6 million shares of stock awards. Each share issued from May 20, 2008 through May 18, 2010 as restricted stock bonuses, restricted stock units, phantom stock units, performance share bonuses, or performance share units reduces the number of shares available for issuance under the 2006 Plan by one and seventy-four hundredths (1.74) shares, and each share issued as stock options, restricted stock purchases or stock appreciation rights reduced the shares available for issuance under the 2006 Plan on a share-for-share basis. Each share issued from and after May 19, 2010 as restricted stock bonuses, restricted stock units, phantom stock units, performance share bonuses, or performance share units reduces the number of shares available for issuance under the 2006 Plan by one and

seven-tenths (1.7) shares, and each share issued as stock options, restricted stock purchases or stock appreciation rights reduces the shares available for issuance under the 2006 Plan on a share-for-share basis. During the nine months ended October 2, 2010, approximately 444,000 options were granted under the 2006 Plan at an exercise price equal to the fair market value on the date of grant, and approximately 684,000 shares of restricted stock and restricted stock units were granted under the 2006 Plan. As of October 2, 2010, approximately 3.8 million shares remained available for grant under the 2006 Plan.

**Table of Contents****Stock Options**

Upon approval in May 2006, the 2006 Plan replaced our previous common stock option plans and equity incentive plans. As of October 2, 2010, we had 2.9 million options issued and outstanding under the 2006 Plan and the replaced plans. Options under the 2006 Plan may be granted by the Board of Directors at the fair market value on the date of grant and generally become fully exercisable within four years after the grant date and expire between five and ten years from the date of grant. Vesting on some options granted to officers may be accelerated in certain circumstances following a change in control of the Company.

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

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Risk-free interest rate (weighted average)	2.13%	3.08%	3.05%	2.34%
Expected volatility	40%	53%	40%	53%
Expected option term (years)	4.83	4.90 to 6.03	4.88 to 6.04	4.91 to 6.02
Dividends	None	None	None	None

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

As of October 2, 2010, there was \$4.2 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to stock options, which expense is expected to be recognized over a weighted average period of 1.40 years. As of October 2, 2010, there was \$0.9 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to stock options, which expense is expected to be recognized over a weighted average period of 1.40 years. The aggregate intrinsic value of in-the-money options outstanding was \$49.9 million, based on the closing price of our common stock of \$37.12 on October 1, 2010, the last trading day in the nine months ended October 2, 2010. As of October 2, 2010, the aggregate intrinsic value of options currently exercisable was \$37.0 million and the intrinsic value of options vested and expected to vest was \$49.2 million.

The total intrinsic value of options exercised for the three months ended October 2, 2010 and October 3, 2009 was \$0.4 million and \$3.4 million, respectively. The total intrinsic value of options exercised for the nine months ended October 2, 2010 and October 3, 2009 was \$32.4 million and \$6.0 million, respectively.

Stock option activity is summarized as follows:

	Number of Options (in thousands)	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contract Life (years)
Outstanding options at January 2, 2010	3,857	\$ 17.29	5.60
Granted	444	30.20	
Exercised	(1,377)	16.00	
Forfeited or expired	(34)	19.73	

Edgar Filing: THORATEC CORP - Form 10-Q

Outstanding options at October 2, 2010	2,890	\$	19.87	5.93
Outstanding options exercisable at October 2, 2010	1,887	\$	17.52	4.62
Outstanding options vested at October 2, 2010 and expected to vest	2,733	\$	19.49	5.76

The weighted average grant-date fair value of options granted during the nine months ended October 2, 2010 and October 3, 2009 was \$12.62 per share and \$12.06 per share, respectively.

**Table of Contents*****Restricted Stock Awards and Units***

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

***Restricted Stock Awards***

Share-based compensation expense from continuing operations related to restricted stock awards was \$2.3 million for the nine months ended October 2, 2010. As of October 2, 2010, we had \$2.1 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to restricted stock awards, which amount is expected to be recognized over 1.05 years. As of October 2, 2010, we had \$0.7 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to restricted stock awards, which amount is expected to be recognized over 1.05 years. There were no restricted stock awards granted during the nine months ended October 2, 2010.

Restricted stock activity is summarized as follows:

	<b>Number of Shares (in thousands)</b>	<b>Weighted Average Grant Date Fair Value</b>
Outstanding unvested restricted stock at January 2, 2010	609	\$ 16.63
Granted		
Vested	(270)	17.15
Forfeited or expired	(20)	16.10
Outstanding unvested restricted stock at October 2, 2010	319	\$ 16.24

***Restricted Stock Units***

Share-based compensation expense from continuing operations related to restricted stock units was \$3.9 million for the nine months ended October 2, 2010. As of October 2, 2010, we had \$13.8 million of unrecognized compensation expense from continuing operations, net of estimated forfeitures, related to restricted stock units, which amount is expected to be recognized over 3.03 years. As of October 2, 2010, we had \$7.0 million of unrecognized compensation expense from discontinued operations, net of estimated forfeitures, related to restricted stock units, which amount is expected to be recognized over 3.03 years. The aggregate intrinsic value of the units outstanding, based on our stock price on October 2, 2010, was \$36.2 million.

Restricted stock unit activity is summarized as follows:

	<b>Number of Units (in thousands)</b>	<b>Weighted Average Grant Date Fair Value</b>	<b>Weighted Average Remaining Contract Life (in years)</b>
Outstanding units at January 2, 2010	463	\$ 24.17	3.12
Granted	684	31.40	
Released	(143)	25.47	
Forfeited or expired	(28)	26.28	



Outstanding units at October 2, 2010	976	\$	28.98	3.03
--------------------------------------	-----	----	-------	------

***Employee Stock Purchase Plan***

In May 2002, our shareholders approved our Employee Stock Purchase Plan ( ESPP ) under which 500,000 shares of common stock were reserved for issuance. In addition, the ESPP provides for an annual, automatic increase of up to 250,000 shares in the total number of shares available for issuance thereunder on March 1 of each year, unless our Board of Directors specifies a smaller increase or no increase. Under this provision, an additional 250,000 shares were reserved for issuance under the ESPP on each of March 1, 2006, March 1, 2008, and March 1, 2009; our Board of Directors specified no increase as of each other year. Eligible employees may purchase a limited number of shares, over a six-month period, of our common stock at 85% of the lower of the market value on the offering date or the market value on the purchase date. During the nine months ended October 2, 2010, 83,791 shares of common stock were issued under the ESPP. As of October 2, 2010, 215,909 shares remained available for issuance under this plan.

**Table of Contents**

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

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

As of October 2, 2010, there was approximately \$71,000 of unrecognized compensation expense from continuing operations and \$25,000 of unrecognized expense from discontinued operations related to ESPP subscriptions that began on May 1, 2010, which amount we expect to recognize during the last quarter of 2010.

**13. Income Taxes**

Our effective income tax rates from continuing operations for the three months ended October 2, 2010 and October 3, 2009, were 37.4% and 33.4%, respectively. Our effective income tax rates from continuing operations for the nine months ended October 2, 2010 and October 3, 2009 were 35.6% and 31.3%, respectively. The increase in our reported income tax rates was primarily attributable to return-to-provision expense associated with an increase in our effective tax rates due to changes in state apportionment factors and the proportion of tax exempt interest to higher pre-tax earnings. In addition, during the three months ended October 2, 2010, we recorded a return-to-provision benefit primarily associated with additional research credits.

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

We remain under audit by the state of California for the tax years 2003 to 2007, which we have adequately reserved. Subsequent to the third quarter of 2010, we received proposed adjustments from the state of California for the tax years 2005 to 2007, which we are currently evaluating.

During the next twelve months, it is reasonably possible that audit resolutions and the expiration of statutes of limitation could potentially reduce our unrecognized tax benefits by up to \$3.8 million. However, this amount may change because we continue to have ongoing negotiations with various taxing authorities throughout the year.

**14. Geographic Information**

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

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

Revenue attributed to a country or region includes product sales to hospitals, physicians and distributors and is based on final destination where the products are sold. During the three and nine months ended October 2, 2010 and October 3, 2009, no customer or international country represented individually greater than 10% of our total product sales. The geographic composition of our product sales from continuing operations was as follows:

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
	(in thousands)			
Domestic	\$ 76,391	\$ 51,892	\$ 238,535	\$ 159,926
International	14,605	13,222	46,831	39,039
Total product sales from continuing operations	\$ 90,996	\$ 65,114	\$ 285,366	\$ 198,965



**Table of Contents****15. Assets Held For Sale**

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher Corporation ( Danaher ) for \$110.0 million in cash upon closing. On July 26, 2010, the sale was terminated as a result of the failure of the parties to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next nine months. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheets as of October 2, 2010 and January 2, 2010 and its results of operations displayed in discontinued operations for all periods presented.

The results of the ITC business are included in discontinued operations for the three and nine months ended October 2, 2010 and October 3, 2009 as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October</b>	<b>October</b>	<b>October</b>	<b>October 3,</b>
	<b>2,</b>	<b>3,</b>	<b>2,</b>	<b>2009</b>
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(in thousands)</b>			
Product sales	\$ 22,041	\$ 22,804	\$ 68,529	\$ 70,478
Cost of product sales	14,697	14,209	45,554	43,901
Gross profit	7,344	8,595	22,975	26,577
Operating expenses:				
Selling, general and administrative	6,518	5,944	20,697	19,831
Research and development	2,872	2,745	8,968	9,157
Amortization of purchased intangible assets		210	269	628
Total operating expenses	9,390	8,899	29,934	29,616
Loss from operations	(2,046)	(304)	(6,959)	(3,039)
Other income:				
Other income	118	75	322	455
Loss before income taxes	(1,928)	(229)	(6,637)	(2,584)
Income tax benefit	745	230	2,940	989
Net income (loss) from discontinued operations	\$ (1,183)	\$ 1	\$ (3,697)	\$ (1,595)

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

	<b>October</b>	<b>January 2, 2010</b>
	<b>2, 2010</b>	<b>(1)</b>
	<b>(in thousands)</b>	
<b>ASSETS</b>		
Current assets:		
Receivables, net of allowances of \$291 and \$522, respectively	\$ 12,627	\$ 18,030
Inventories (2)	21,928	22,300
Prepaid expenses and other assets	1,281	881
Total current assets	35,836	41,211

Edgar Filing: THORATEC CORP - Form 10-Q

Property, plant and equipment, net (3)	16,468		14,737
Goodwill	4,271		4,271
Purchased intangible assets, net	2,715		2,984
Other long-term assets	590		595
Total assets held for sale	\$ 59,880	\$	63,798
<b>LIABILITIES</b>			
Current liabilities:			
Bank overdraft	\$ 870	\$	1,326
Accounts payable	2,545		2,310
Accrued compensation	4,493		4,990
Other accrued liabilities	2,428		2,305
Total current liabilities	10,336		10,931
Other long-term liabilities	1,488		1,446
Total liabilities related to assets held for sale	\$ 11,824	\$	12,377

**Table of Contents**

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

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Finished goods	\$ 6,414	\$ 5,083
Work in process	2,478	3,068
Raw materials	13,036	14,149
Total	\$ 21,928	\$ 22,300

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Land, building and improvements	\$ 4,588	\$ 4,606
Equipment and capitalized software	36,032	35,465
Furniture and leasehold improvements	3,233	3,098
Subtotal	43,853	43,169
Less accumulated depreciation	(27,385)	(28,432)
Total	\$ 16,468	\$ 14,737

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

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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands, except per share data)</b>			
<i>Basic net income (loss) per share calculation</i>				
Net income from continuing operations	\$ 15,480	\$ 11,776	\$ 46,381	\$ 20,832
Net income from continuing operations allocated to participating securities	(86)	(133)	(310)	(267)
Net income from continuing operations attributable to common shareholders	\$ 15,394	\$ 11,643	\$ 46,071	\$ 20,565
Net income (loss) from discontinued operations	\$ (1,183)	\$ 1	\$ (3,697)	\$ (1,595)
Net income (loss) from discontinued operations allocated to participating securities	7		25	20
Net income (loss) from discontinued operations attributable to common shareholders	\$ (1,176)	\$ 1	\$ (3,672)	\$ (1,575)
Net income	\$ 14,297	\$ 11,777	\$ 42,684	\$ 19,237
Net income allocated to participating securities	(79)	(133)	(285)	(247)
Net income attributable to common shareholders	\$ 14,218	\$ 11,644	\$ 42,399	\$ 18,990
	58,138	56,045	57,473	55,787

Weighted average number of common shares  
used to compute basic net income per  
common share

Basic net income (loss) per common share

from:

Continuing operations	\$ 0.26	\$ 0.21	\$ 0.80	\$ 0.37
Discontinued operations	(0.02)		(0.06)	(0.03)
Total	\$ 0.24	\$ 0.21	\$ 0.74	\$ 0.34



**Table of Contents**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands, except per share data)</b>			
<i>Diluted net income (loss) per share calculation</i>				
Net income from continuing operations	\$ 15,480	\$ 11,776	\$ 46,381	\$ 20,832
Interest expense on senior subordinated convertible notes (after tax)	1,812		5,312	
Net income for diluted share calculation	17,292	11,776	51,693	20,832
Net income from continuing operations allocated to participating securities	(84)	(131)	(302)	(264)
Net income from continuing operations attributable to common shareholders	\$ 17,208	\$ 11,645	\$ 51,391	\$ 20,568
Net income (loss) from discontinued operations	\$ (1,183)	\$ 1	\$ (3,697)	\$ (1,595)
Net income (loss) from discontinued operations allocated to participating securities	7		25	20
Net income (loss) from discontinued operations attributable to common shareholders	\$ (1,176)	\$ 1	\$ (3,672)	\$ (1,575)
Net income	\$ 14,297	\$ 11,777	\$ 42,684	\$ 19,237
Interest expense on senior subordinated convertible notes (after tax)	1,812		5,312	
Net income for diluted share calculation	16,109	11,777	47,996	19,237
Net income allocated to participating securities	(77)	(131)	(277)	(244)
Net income attributable to common shareholders	\$ 16,032	\$ 11,646	\$ 47,719	\$ 18,993
Weighted average number of common shares used to compute basic net income (loss) per common share attributable to common shares	58,138	56,045	57,473	55,787
Dilutive effect of stock-based compensation plans	1,303	1,323	1,502	1,348
Dilutive effect on conversion of senior subordinated convertible notes	7,171		7,241	

Weighted average number of common shares used to compute diluted net income (loss) per common share	66,612	57,368	66,216	57,135
Diluted net income (loss) per common share from				
Continuing operations	\$ 0.26	\$ 0.20	\$ 0.78	\$ 0.36
Discontinued operations	(0.02)		(0.06)	(0.03)
Total	\$ 0.24	\$ 0.20	\$ 0.72	\$ 0.33

The weighted average unvested restricted stock awards outstanding were 323,582 and 638,105 for the three months ended October 2, 2010 and October 3, 2009, respectively. The weighted average unvested restricted stock awards outstanding were 386,808 and 724,469 for the nine months ended October 2, 2010 and October 3, 2009, respectively.

Subsequent to the original issuance of the unaudited condensed consolidated financial statements for the period ended October 3, 2009, management determined that the net income (loss) per share calculations for the three and nine months ended October 3, 2009 did not properly reflect the restricted share awards as participating securities under the two-class method and thus were inappropriately reflected in the number of common shares to be used in the computation of net income (loss) per share. The change to the calculation of the two-class method had no impact on the reported net income (loss) per share for the three and nine months ended October 3, 2009. The change to the calculation of the two-class method resulted in a decrease in the shares reported as used in the computation of both basic and diluted net income (loss) per share of approximately 638,000 and 724,000 for the three and nine months ended October 3, 2009, respectively. The shares previously included in the calculations of basic and diluted net income (loss) per share for the three months and nine months ended October 3, 2009 were as follows:

	<b>Three Months Ended October 3, 2009</b>	<b>Nine Months Ended October 3, 2009</b>
	(in thousands)	
Basic	56,683	56,511
Diluted	58,006	57,859

**Table of Contents**

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

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
	(in thousands)			
Options to purchase shares not included in the computation of diluted income per share because their inclusion would be anti-dilutive	33	333	344	280

The computation of diluted net income per common share for the three and nine months ended October 3, 2009 excludes the effect of assuming the conversion of our senior subordinated convertible notes, which are convertible at \$19.72 per share into 7.3 million shares of common stock, because the effect would have been anti-dilutive.

**17. Subsequent Event**

On November 4, 2010, we sold our wholly-owned subsidiary, International Technidyne Corporation, to ITC Nexus Holding Company, Inc. ( Nexus ) for \$55 million in cash pursuant to a Stock Purchase Agreement, dated as of November 4, 2010, by and between the Company and Nexus.

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

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

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

**OVERVIEW****Continuing Operations Cardiovascular Business**

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

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

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

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

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

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

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

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

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

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

***The HeartMate XVE***

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

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

***The Paracorporeal Ventricular Assist Device***

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

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

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

**Table of Contents*****The Implantable Ventricular Assist Device***

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

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

***The CentriMag***

The CentriMag is manufactured by Levitronix and is based on their magnetically levitated bearingless motor technology. We entered into a distribution agreement with Levitronix in August 2007, with an initial term effective through December 2011, to distribute the CentriMag in the U.S. The CentriMag is 510(k) cleared by the FDA for use up to nine hours in patients requiring short-term extracorporeal circulatory support during cardiac surgery. Additionally, CentriMag is approved under a FDA humanitarian device exemption to be used as a right ventricular assist device for periods of support up to thirty days in patients in cardiogenic shock due to acute right ventricular failure. In May 2008, Levitronix received approval to commence a U.S. pivotal trial to demonstrate safety and effectiveness of the CentriMag for periods of support up to thirty days. Levitronix has CE Mark approval in Europe to market the product to provide support for up to thirty days.

***Vascular Graft Products***

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

**Discontinued Operations International Technidyne Corporation ( ITC )**

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

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

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

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher Corporation ( Danaher ) for \$110.0 million in cash upon closing. On July 26, 2010, the sale was terminated as a result of the failure of the parties to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next nine months. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheet as of October 2, 2010 and January 2, 2010 and its results of operations are displayed in discontinued operations for all periods presented.

On November 4, 2010, we sold our wholly-owned subsidiary, International Technidyne Corporation, to ITC Nexus Holding Company, Inc. ( Nexus ) for \$55 million in cash pursuant to a Stock Purchase Agreement, dated as of November 4, 2010, by and between the Company and Nexus.

**Critical Accounting Policies and Estimates**

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

**Table of Contents**

***Revenue Recognition***

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

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

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

***Reserves***

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

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

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

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

**Table of Contents*****Income Taxes***

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

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

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

***Evaluation of Purchased Intangible Assets and Goodwill for Impairment***

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

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

***Valuation of Share-Based Awards***

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



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

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

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

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

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

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Assets and liabilities utilizing Level 3 inputs include auction rate securities, and our purchased intangible asset valuations. Given the current credit market illiquidity for auction rate securities, our estimates are subject to significant judgment by management.

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

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

**Table of Contents****Results of Operations**

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

	Three Months Ended				Nine Months Ended			
	October 2, 2010		October 3, 2009		October 2, 2010		October 3, 2009	
	(in thousands, except for percentage data)							
Product sales	\$ 90,996	100%	\$ 65,114	100%	\$ 285,366	100%	\$ 198,965	100%
Cost of product sales	28,621	32	19,976	31	90,771	32	67,027	34
Gross profit	62,375	68	45,138	69	194,595	68	131,938	66
Operating expenses:								
Selling, general and administrative	21,104	23	18,283	28	64,010	22	62,625	32
Research and development	12,332	14	10,605	16	44,135	16	31,705	16
Amortization of purchased intangible assets	2,446	3	2,359	4	7,326	3	7,441	4
Total operating expenses	35,882	40	31,247	48	115,471	41	101,771	52
Income from operations	26,493	28	13,891	21	79,124	27	30,167	14
Other income and (expense):								
Interest expense and other	(3,125)	(3)	(3,261)	(5)	(9,280)	(3)	(9,167)	(5)
Interest income and other	1,362	2	7,060	11	4,261	2	9,304	5
Impairment of investment	(11)				(2,057)	(1)		
Income before income taxes	24,719	27	17,690	27	72,048	25	30,304	14
Income tax expense	(9,239)	(10)	(5,914)	(9)	(25,667)	(9)	(9,472)	(5)
Net income from continuing operations	15,480	17	11,776	18	46,381	16	20,832	9
Net income (loss) from discontinued operations, net of tax	(1,183)	(1)	1		(3,697)	(1)	(1,595)	(1)

Net income	\$ 14,297	16	\$ 11,777	18	\$ 42,684	15	\$ 19,237	8
------------	-----------	----	-----------	----	-----------	----	-----------	---

**Three and nine months ended October 2, 2010 and October 3, 2009***Continuing Operations**Product Sales*

Product sales were as follows:

	Three Months Ended			Nine Months Ended		
	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change
Product sales	\$ 90,996	\$ 65,114	40%	\$ 285,366	\$ 198,965	43%

In the third quarter of 2010 as compared to the third quarter of 2009, product sales increased by \$25.9 million primarily due to higher volume from worldwide sales of our HeartMate product line, including Go-Gear peripherals introduced in the third quarter of 2009, which was in part offset by a decline in sales of the Thoratec product line, and fluctuations in foreign currency exchange rates.

In the first nine months of 2010 as compared to the first nine months of 2009, product sales increased by \$86.4 million primarily due to higher volume from worldwide sales of our HeartMate product line, including Go-Gear peripherals, which was in part offset by a decline in the Thoratec product line and fluctuations in foreign currency exchange rates. In North America, 13 HeartMate II centers have been added in the first nine months of 2010 bringing the total to 133 centers. Outside of North America, we added 18 centers in the first nine months of 2010, bringing the total to 109 centers.

Sales originating outside of the U.S. and U.S. export sales accounted for approximately 16% and 20% of our total product sales in the third quarter of 2010 and 2009, respectively, and approximately 16% and 20% of our total product sales in the first nine months of 2010 and 2009, respectively.

**Table of Contents****Gross Profit**

Gross profit and gross margin were as follows:

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
	(in thousands, except percentages)			
Total gross profit	\$ 62,375	\$ 45,138	\$ 194,595	\$ 131,938
Total gross margin	68.5%	69.3%	68.2%	66.3%

In the third quarter of 2010 as compared to the third quarter of 2009, gross margin decreased by 0.8 percentage points primarily due to unfavorable warranty reserves and unfavorable foreign currency exchange rates partially offset by favorable manufacturing variances driven by volume and the launch of Go-Gear peripherals.

In the first nine months of 2010 as compared to the first nine months of 2009, gross margin increased by 1.9 percentage points, primarily due to favorable manufacturing variances driven by volume, favorable inventory reserves from lower charges taken in the first nine months of 2010 as compared to the first nine months of 2009 and the launch of Go-Gear peripherals, partially offset by unfavorable warranty reserves.

**Selling, General and Administrative**

Selling, general and administrative expenses were as follows:

	Three Months Ended			Nine Months Ended		
	October 2, 2010	October 3, 2009	% Change	October 2, 2010	October 3, 2009	% Change
	(in thousands)			(in thousands)		
Total selling, general and administration	\$ 21,104	\$ 18,283	15%	\$ 64,010	\$ 62,625	2%

In the third quarter of 2010 as compared to the third quarter of 2009, selling, general and administrative costs increased by \$2.8 million due to higher personnel costs of \$1.9 million associated with the expansion of our sales force and other market development initiatives and \$0.9 million primarily due to market fluctuations associated with our deferred compensation plan liabilities and legal fees related to business development activity.

In the first nine months of 2010 as compared to the first nine months of 2009, selling, general and administrative costs increased by \$1.4 million. This increase was primarily due to \$7.5 million from the expansion of our sales force and other market development initiatives, including users meetings, partially offset by a decrease of \$6.1 million in corporate expenses. This decrease in corporate costs was primarily due to the \$12.3 million expense related to the terminated merger agreement with HeartWare International Inc. ( HeartWare ) in 2009, partially offset by a \$6.2 million increase in personnel, legal and market fluctuations associated with our deferred compensation plan liabilities.

**Table of Contents****Research and Development**

Research and development expenses were as follows:

	Three Months Ended			Nine Months Ended		
	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change
Total research and development	\$ 12,332	\$ 10,605	16%	\$ 44,135	\$ 31,705	39%

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

In the third quarter of 2010 as compared to the third quarter of 2009, costs increased by \$1.7 million primarily due to an increase in personnel costs associated with new HeartMate II platform enhancements, development of HeartMate III and other new product technology.

In the first nine months of 2010 as compared to the first nine months of 2009, costs increased by \$12.4 million primarily due to the acquisition of Percutaneous Heart Pump technology of \$8.5 million, new HeartMate II platform enhancements, development of HeartMate III and other new product technology.

**Amortization of Purchased Intangible Assets**

Amortization of purchased intangible assets was \$2.4 million in the third quarters of each of 2010 and 2009. Amortization of purchased intangible assets in the first nine months of 2010 was \$7.3 million as compared to \$7.4 million in the first nine months of 2009. The \$0.1 million decrease in amortization expense for the first nine months of 2010 was due to certain intangible assets being fully amortized.

**Interest Expense and Other**

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

	Three Months Ended			Nine Months Ended		
	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change	October 2, 2010 (in thousands)	October 3, 2009 (in thousands)	% Change
Interest expense	\$ 3,022	\$ 3,158	(4)%	\$ 8,866	\$ 8,858	
Amortization of debt issuance costs related to senior subordinated convertible notes	103	103		315	309	2%
Loss on extinguishment of senior subordinated convertible notes				99		
Total interest expense	\$ 3,125	\$ 3,261		\$ 9,280	\$ 9,167	

Interest expense, which is comprised primarily of the senior subordinated convertible notes, is calculated using the interest rate method which increases interest expense over the term of the debt. During 2010, 4,045 bonds had been converted (247,427 bonds originally issued), resulting in \$0.1 million less interest expense in the third quarter of 2010 as compared to the third quarter of 2009 and a comparable interest expense for the first nine months of 2010 and 2009.

In addition, we recorded a loss on extinguishment of \$0.1 million from the 4,045 bonds converted.

**Table of Contents****Interest Income and Other**

Interest income and other consisted of the following:

	Three Months Ended			Nine Months Ended		
	October 2, 2010	October 3, 2009	% Change	October 2, 2010	October 3, 2009	% Change
	(in thousands)			(in thousands)		
Interest income	\$ 1,183	\$ 1,561	(24)%	\$ 4,054	\$ 4,284	(5)%
Foreign currency, net	(267)	239	(212)%	(146)	(274)	47%
Recording of conversion option upon termination of merger agreement		3,454			3,454	
Mark-to-market adjustment on HeartWare conversion option		1,786			1,786	
Other	446	20	2,130%	353	54	554%
Total interest income and other	\$ 1,362	\$ 7,060		\$ 4,261	\$ 9,304	

Interest income decreased \$0.4 million in the third quarter of 2010 as compared to the third quarter of 2009 primarily due to a decline in market interest rates, in part offset by an increase in cash and investment balances. During the third quarter of 2009 we recorded income of \$3.5 million in connection with the receipt of the conversion option under the HeartWare loan agreement and a \$1.8 million favorable mark-to-market adjustment on this conversion option. Foreign currency gains decreased to a loss position in the same period by \$0.5 million due to fluctuations in foreign exchange rates. Other income increased by \$0.4 million primarily due to higher royalty income earned and the change in mark-to-market value of our deferred compensation plan assets during the third quarter of 2010.

Interest income decreased by \$0.2 million in the first nine months of 2010 as compared to the first nine months of 2009 primarily due to a decline in market interest rates and shortened maturities on our investment portfolio, despite an increase in cash and investment balances. During the third quarter of 2009 we recorded income of \$3.5 million in connection with the receipt of the conversion option under the HeartWare loan agreement and a \$1.8 million favorable mark-to-market adjustment on this conversion option. Other income increased by \$0.3 million primarily due to higher royalty income earned and the change in our mark-to-market value of our deferred compensation plan assets during the first nine months of 2010.

**Impairment on Investment**

During the first nine months of 2010, we recorded an impairment charge of \$2.1 million for our entire investment in Acorn Cardiovascular, Inc., a start-up medical device company.

**Income Taxes**

Our effective income tax rates for the three months ended October 2, 2010 and October 3, 2009 were 37.4% and 33.4%, respectively. The increase in our reported income tax rate of approximately four percentage points was primarily due to return-to-provision expense associated with an increase in our effective tax rate due to changes in state apportionment factors and the proportion of tax exempt interest to higher pre-tax earnings. In addition, for the three months ended October 2, 2010 we recorded a return-to-provision benefit primarily associated with additional research credits.

Our effective income tax rates for the nine months ended October 2, 2010 and October 3, 2009 were 35.6% and 31.3%, respectively. The increase in our reported income tax rate of approximately four percentage points was

primarily due to return-to-provision expense associated with an increase in our effective tax rate due to changes in state apportionment factors and the proportion of tax exempt interest to higher pre-tax earnings. In addition, in the first quarter of 2009, a discrete benefit of \$0.9 million was recorded for a change in California law.

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

We remain under audit by the state of California for the tax years 2003 to 2007, which we have adequately reserved. Subsequent to the third quarter of 2010, we received proposed adjustments from the state of California for the tax years 2005 to 2007, which we are currently evaluating.



**Table of Contents**

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

**Analysis of Discontinued Operations**

On April 25, 2010, we entered into a Stock Purchase Agreement to sell the ITC division to Danaher for \$110.0 million in cash upon closing. On July 26, 2010, the sale was terminated as a result of the failure of the Company and Danaher to agree on the status of certain aspects of ITC's quality system and regulatory filings. We expect to locate another buyer and complete the sale of ITC within the next nine months. As such, the ITC division is classified as held for sale on the condensed consolidated balance sheets as of October 2, 2010 and January 2, 2010 and its results of operations displayed in discontinued operations for all periods presented.

Discontinued operations incurred a loss of \$1.2 million in the third quarter of 2010 compared to income of approximately \$1,000 in the third quarter of 2009. The increase in the loss from discontinued operations was primarily due to lower sales as a result of competitive activity and lower gross margin driven by unfavorable manufacturing variances.

Discontinued operations incurred a loss of \$3.7 million during the first nine months of 2010 compared to a loss of \$1.6 million in the first nine months of 2009. The increase in the loss from discontinued operations was primarily due to lower sales as a result of competitive activity and lower gross margin driven by unfavorable manufacturing variances.

On November 4, 2010, we sold our wholly-owned subsidiary, International Technidyne Corporation, to ITC Nexus Holding Company, Inc. (Nexus) for \$55 million in cash pursuant to a Stock Purchase Agreement, dated as of November 4, 2010, by and between the Company and Nexus.

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

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

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

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

	<b>October 2, 2010</b>	<b>January 2, 2010</b>
	<b>(in thousands)</b>	
Cash and cash equivalents	\$ 50,709	\$ 27,787
Short-term investments	337,853	279,174
Long-term investments	21,578	24,634
Total cash, cash equivalents and investments	\$ 410,140	\$ 331,595

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

As of October 2, 2010, we owned approximately \$24.7 million face amount of auction rate securities classified as long-term. The assets underlying these investments are student loans backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically

every seven to thirty-five days. Beginning in February of 2008, these auctions began to fail. The principal amount of these auction rate securities will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption, or they are paid at maturity.

**Table of Contents**

We recorded an estimated cumulative unrealized loss of \$3.1 million (\$1.9 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive loss within shareholders' equity. In addition, our management reviews impairments and credit losses associated with its investments, including auction rate securities, to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of any other-than-temporary impairment event. We do not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; we intend to hold the investment to recovery and based on a more-likely-than-not probability assessment we will not be required to sell the security before recovery; and we deem that it is not probable that we will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the impairment was charged to other comprehensive loss. Further, we continue to liquidate investments in auction rate securities as opportunities arise. In the third quarter of 2010 we liquidated \$3.0 million of our auction rate securities at par value through a successful auction.

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

We intend and have the ability to hold these auction rate securities until the market recovers, and the securities recover to par or until maturity. We do not anticipate having to sell these securities in order to operate our business. We believe that, based on our current cash, cash equivalents and short-term marketable security investment balances of \$388.6 million as of October 2, 2010, the current lack of liquidity in the credit and capital markets will not have an impact on our liquidity, our cash flow or our ability to fund our operations. If the issuers of the auction rate securities are unable to successfully complete future auctions and their credit ratings deteriorate, we may in the future be required to record other-than-temporary impairment charge on these investments. It could conceivably take until the final maturity of the underlying notes (up to 30 years) to realize our investments' recorded value.

*Senior Subordinated Convertible Notes*

In 2004, we completed the sale of \$143.8 million initial principal amount of senior subordinated convertible notes due in 2034. The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Holders of the senior subordinated convertible notes may convert their convertible notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on September 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of our common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of our common stock at a conversion rate of 29.462 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, we may, at our option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes. As of October 2, 2010, 4,045 of the 247,427 bonds originally issued have been submitted to be converted and we elected to pay cash in lieu of shares for these bonds.

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

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

**Table of Contents*****Cash Flow Activities from Continuing Operations***

Following is a summary of our cash flow activities:

	<b>Nine Months Ended</b>	
	<b>October 2, 2010</b>	<b>October 3, 2009</b>
	<b>(in thousands)</b>	
Net cash provided by continuing operating activities	\$ 61,372	\$ 23,113
Net cash used in continuing investing activities	(61,767)	(110,057)
Net cash provided by continuing financing activities	23,321	7,368
Effect of exchange rate changes on cash and cash equivalents	(4)	(207)
Net increase (decrease) in cash and cash equivalents	\$ 22,922	\$ (79,783)

***Cash Provided by Continuing Operating Activities***

For the nine months ended October 2, 2010, cash provided by operating activities was \$61.4 million. This amount included net income from continuing operations of \$46.4 million increased by non-cash adjustments to net income of \$33.1 million primarily comprised of \$5.0 million related to depreciation, \$7.3 million related to amortization, \$10.3 million related to tax benefit related to stock options, \$9.6 million related to share-based compensation expense, and non-cash interest on senior subordinated convertible notes of \$7.2 million. These were partially offset by a decrease of \$9.5 million related to excess tax benefits from share-based compensation and \$4.0 million change in our net deferred tax liability. Changes in assets and liabilities used cash of \$18.1 million primarily due to increases in tax payments, inventories, and receivables, partially offset by an increase in accounts payable and other liabilities.

***Cash Used in Continuing Investing Activities***

For the nine months ended October 2, 2010, cash used in investing activities was \$61.8 million, primarily due to purchases of investments of \$398.9 million, partially offset by sales and maturities of investments of \$338.6 million. In addition, we made \$2.8 million for purchases of property, plant and equipment which included \$2.0 million for the expansion of our research and development equipment and facilities and improvements to our Pleasanton office, and we made \$1.4 million for purchases of patents, partly offset by a receipt of \$2.8 million from a loan collection from Levitronix.

***Cash Provided by Continuing Financing Activities***

For the nine months ended October 2, 2010, cash provided by financing activities was \$23.3 million, and was comprised primarily of \$22.0 million from proceeds related to stock option exercises, \$1.9 million from proceeds from stock issued under our employee stock purchase plan and \$9.5 million from excess tax benefits from stock option exercises, partially offset by \$4.7 million of restricted stock purchased for payment of income tax withholding due upon vesting and \$5.4 million used to settle the extinguishment of 4,045 of our senior subordinated convertible notes.

**Table of Contents****Cash Flow Activities from Discontinued Operations**

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

	<b>Nine Months Ended</b>	
	<b>October</b>	<b>October 3,</b>
	<b>2,</b>	<b>2009</b>
	<b>2010</b>	
	<b>(in thousands)</b>	
Net cash provided by operating activities	\$ 2,944	\$ 2,821
Net cash used in investing activities	(2,488)	(2,091)
Net decrease in bank overdraft	\$ 456	\$ 730

For the nine months ended October 2, 2010, cash provided by operating activities was \$2.9 million. This amount included net loss from discontinuing operations of \$3.7 million, offset by non-cash items of \$4.4 million comprising of \$1.4 million of depreciation and amortization and \$3.0 million of share-based compensation expenses. Changes in assets and liabilities provided cash of \$2.2 million primarily due to decreases in receivables, partially offset by a decrease in accounts payable and other liabilities.

For the nine months ended October 2, 2010, cash used in investing activities was \$2.5 million, primarily due to purchases of property, plant and equipment related to the purchase of research and development equipment and improvements to the manufacturing facility.

**Off Balance Sheet Arrangements**

We maintain an Irrevocable Standby Letter of Credit as part of our workers' compensation insurance program. The Letter of Credit is not collateralized. The Letter of Credit automatically renews on June 30th of each year, unless terminated by one of the parties. As of October 2, 2010, our Letter of Credit was approximately \$0.8 million.

**Contractual Obligations**

As of October 2, 2010, the liability for uncertain tax positions was \$9.8 million, including interest and penalties. Due to the high degree of uncertainty regarding the timing of potential future cash flows associated with these liabilities, we are unable to make a reasonably reliable estimate of the amount and period in which these liabilities might be paid.

During the three and nine months ended October 2, 2010 there were no other material changes to our contractual obligations reported in our 2009 Annual Report on Form 10-K, outside our normal course of business.

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

Our investment portfolio is made up of marketable investments in money market funds, auction rate securities, U.S. Treasury securities and debt instruments of government agencies, local municipalities, and high quality corporate issuers. All investments are carried at fair market value and are treated as available-for-sale. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature due to the frequency with which the interest rate is reset and because such marketable securities represent the investment of cash that is available for current operations. Our auction rate securities that are not liquid are classified as long-term. Our holdings of the securities of any one issuer, except government agencies, do not exceed 10% of the portfolio. If interest rates rise, the market value of our investments may decline, which could result in a loss if we were forced to sell an investment before its scheduled maturity. If interest rates were to rise or fall from current levels by 25 basis points and by 50 basis points, the change in our net unrealized gain or loss on investments would be \$0.5 million and \$1.0 million, respectively. We do not utilize derivative financial instruments to manage interest rate risks. Our senior subordinated convertible notes do not bear interest rate risk as the notes were issued at a fixed rate of interest.

**Table of Contents****Foreign Currency Rate Fluctuations**

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

Effective January 3, 2010, we changed our functional currency for our U.K. subsidiary from U.K. pounds to euros. This change did not have a material impact on our condensed consolidated financial statements; however, the change did impact our foreign currency hedging contracts. As of October 2, 2010, we owned forward contracts to sell euros to U.S. dollars with a notional value of \$8.0 million, to sell U.S. dollars to euro with a notional value of \$3.6 million and to sell U.K. pounds to euros with a notional value of £0.6 million, as compared to October 3, 2009, when we owned forward contracts to sell euros to U.S. dollars with a notional value of \$9.6 million and to purchase U.K. pounds from U.S. dollars with a notional value of £5.5 million. As of October 2, 2010, our forward contracts had an average exchange rate of one U.S. dollar to 1.34796 euros and one U.K. pound to 1.15048 euros. The potential fair value loss for a hypothetical 25% adverse change in foreign currency exchange rates as of October 2, 2010 would be approximately \$2.1 million.

**ITEM 4. CONTROLS AND PROCEDURES**

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

***Disclosure Controls and Procedures***

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, as of October 2, 2010. The evaluation of our disclosure controls and procedures included a review of our processes and the effect on the information generated for use in this Quarterly Report on Form 10-Q. In the course of this evaluation, we sought to identify any significant deficiencies or material weaknesses in our disclosure controls and procedures, to determine whether we had identified any acts of fraud involving personnel who have a significant role in our disclosure controls and procedures, and to confirm that any necessary corrective action, including process improvements, was taken. This type of evaluation is done quarterly so that our conclusions concerning the effectiveness of these controls can be reported in our periodic reports filed with the SEC. The overall goals of these evaluation activities are to monitor our disclosure controls and procedures and to make modifications as necessary. We intend to maintain these disclosure controls and procedures, modifying them as circumstances warrant.

Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that as of October 2, 2010 the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer, as appropriate to allow for timely decisions regarding required disclosures.

***Changes to Internal Controls***

There have been no changes in our internal controls over financial reporting during the quarter ended October 2, 2010 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

**Table of Contents**

***Inherent Limitations on Controls and Procedures***

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

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. While our Chief Executive Officer and Chief Financial Officer have concluded that, as of October 2, 2010, the design of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, was effective, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.



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

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

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

There were no unregistered sales of our equity securities during the three months ended October 2, 2010.

The following table sets forth certain information about our common stock repurchased during the three months ended October 2, 2010:

	Total number of shares purchased (2)	Average price paid per share (in thousands, except per share data)	Total number of shares purchased under publicly announced programs (1)	Approximate value of shares authorized to be purchased under publicly announced programs
July 4, 2010 through July 31, 2010	1.8	\$ 44.16		\$
August 1, 2010 through August 28, 2010	1.5	34.88		
August 29, 2010 through October 2, 2010	1.7	36.50		
Total	5.0	\$ 38.73		\$

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

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

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

dollar value that  
may yet be  
purchased under  
our publicly  
announced  
repurchase  
programs.

**ITEM 5: OTHER INFORMATION**

On November 4, 2010, we sold our wholly-owned subsidiary, International Technidyne Corporation, to ITC Nexus Holding Company, Inc. ( Nexus ) for \$55 million in cash pursuant a Stock Purchase Agreement, dated November 4, 2010, by and between the Company and Nexus ("Purchase Agreement"). Subject to the limitations set forth in the Purchase Agreement, the Company is providing indemnification to Nexus for (a) breaches of certain representations and warranties, (b) covenant breaches, (c) specified U.S. Food and Drug Administration matters and (d) other customary matters.

The description of the Purchase Agreement is qualified in its entirety by reference to the full text of the document, a copy of which is attached as Exhibit [2.1] hereto.

The Purchase Agreement contains representations and warranties that the parties made to each other as of specific dates. Except for its status as a contractual document that establishes and governs the legal relations among the parties, the Purchase Agreement is not intended to be a source of factual, business or operational information about any of the parties thereto. The representations and warranties were made as of specific dates, only for purposes of the proposed transactions, and solely for the benefit of the parties to the Purchase Agreement. These representations and warranties may be subject to limitations agreed between the parties, including being qualified by disclosures between the parties. The representations and warranties may have been made to allocate risks among the parties, including where the parties do not have complete knowledge of all facts, instead of establishing matters as facts. Furthermore, those representations and warranties may be subject to standards of materiality applicable to the contracting parties that differ from those applicable to investors.

Accordingly, investors and security holders should not rely on such representations and warranties as characterizations of the actual state of facts or circumstances. Moreover, information concerning the subject matter of such representations and warranties may change after the date of these representations and warranties.

**Table of Contents**

**ITEM 6. EXHIBITS**

- 2.1 Stock Purchase agreement, dated as of November 4, 2010, by and between Thoratec Corporation and ITC Nexus Holding Company, Inc.
  
- 31.1 Section 302 Certification of Chief Executive Officer.
  
- 31.2 Section 302 Certification of Chief Financial Officer.
  
- 32.1 Section 906 Certification of Chief Executive Officer.
  
- 32.2 Section 906 Certification of Chief Financial Officer.
  
- 101\*\*\* The following materials from Registrant's Quarterly Report on Form 10-Q for the quarter ended October 2, 2010, formatted in Extensible Business Reporting Language (XBRL) includes: (i) Condensed Consolidated Balance Sheets as of October 2, 2010 and January 2, 2010, (ii) Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 2, 2010 and October 3, 2009, (iii) Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 2, 2010 and October 3, 2009, and (iv) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.

**Table of Contents**

**SIGNATURES**

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

THORATEC CORPORATION

Date: November 4, 2010

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

Date: November 4, 2010

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