

Cardiovascular Systems Inc  
Form 10-Q  
February 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

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

For the quarterly period ended December 31, 2011

Commission File No. 000-52082

**CARDIOVASCULAR SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of

No. 41-1698056  
(IRS Employer

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incorporation or organization)

Identification No.)

651 Campus Drive

St. Paul, Minnesota 55112-3495

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (651) 259-1600

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

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

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

Large accelerated filer  Accelerated filer

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

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

The number of shares outstanding of the registrant's common stock as of February 3, 2012 was: Common Stock, \$0.001 par value per share, 18,002,967 shares.

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**Cardiovascular Systems, Inc.**

**Consolidated Financial Statements**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Cardiovascular Systems, Inc.****Consolidated Balance Sheets****(Dollars in Thousands, except per share and share amounts)****(Unaudited)**

	<b>December 31, 2011</b>	<b>June 30, 2011</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 24,558	\$ 21,159
Accounts receivable, net	12,460	13,254
Inventories	7,963	5,818
Prepaid expenses and other current assets	1,413	797
<b>Total current assets</b>	<b>46,394</b>	<b>41,028</b>
Property and equipment, net	2,388	2,383
Patents, net	2,499	2,314
Debt conversion option and other assets	726	1,033
<b>Total assets</b>	<b>\$ 52,007</b>	<b>\$ 46,758</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Current maturities of long-term debt	\$ 2,337	\$ 3,813
Accounts payable	5,633	5,181
Deferred grant incentive	995	647
Accrued expenses	5,300	5,545
<b>Total current liabilities</b>	<b>14,265</b>	<b>15,186</b>
Long-term liabilities		
Long-term debt, net of current maturities	15,403	8,331
Deferred grant incentive	336	1,497
Other liabilities	103	109
<b>Total long-term liabilities</b>	<b>15,842</b>	<b>9,937</b>
<b>Total liabilities</b>	<b>30,107</b>	<b>25,123</b>
Commitments and contingencies		
Common stock, \$0.001 par value; authorized 100,000,000 common shares at December 31, 2011 and June 30, 2011; issued and outstanding 17,895,650 at December 31, 2011 and 16,987,068 at June 30, 2011, respectively	18	17
Additional paid in capital	182,835	174,157
Common stock warrants	9,489	9,909
Accumulated deficit	(170,442)	(162,448)

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Total stockholders' equity	21,900	21,635
Total liabilities and stockholders' equity	\$ 52,007	\$ 46,758

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

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**Cardiovascular Systems, Inc.**  
**Consolidated Statements of Operations**  
(Dollars in thousands, except per share and share amounts)  
(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Revenues	\$ 19,718	\$ 18,756	\$ 38,378	\$ 36,921
Cost of goods sold	4,560	3,972	8,906	8,113
Gross profit	15,158	14,784	29,472	28,808
Expenses				
Selling, general and administrative	15,733	14,687	31,083	30,183
Research and development	3,084	2,114	5,148	4,536
Total expenses	18,817	16,801	36,231	34,719
Loss from operations	(3,659)	(2,017)	(6,759)	(5,911)
Interest and other, net	(476)	27	(1,235)	(347)
Net loss	\$ (4,135)	\$ (1,990)	\$ (7,994)	\$ (6,258)
Net loss per common share:				
Basic and Diluted	\$ (0.23)	\$ (0.13)	\$ (0.45)	\$ (0.40)
Weighted average common shares used in computation:				
Basic and Diluted	17,781,326	15,827,046	17,634,134	15,598,101

The accompanying notes are an integral part of these unaudited consolidated financial statements

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**Cardiovascular Systems, Inc.**  
**Consolidated Statements of Cash Flows**

(Dollars in thousands)

(Unaudited)

	<b>Six Months Ended</b>	
	<b>December 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities</b>		
Net loss	\$ (7,994)	\$ (6,258)
Adjustments to reconcile net loss to net cash used in operations		
Depreciation and amortization of property and equipment	448	337
Amortization of (premium) discount, net	(21)	9
Provision for doubtful accounts	(30)	(40)
Debt conversion and valuation of conversion options, net	566	(476)
Stock-based compensation	2,719	3,905
Other		250
Changes in assets and liabilities		
Accounts receivable	824	(1,305)
Inventories	(2,145)	(2)
Prepaid expenses and other assets	53	86
Accounts payable	452	761
Accrued expenses and other liabilities	(1,064)	(721)
Net cash used in operations	(6,192)	(3,454)
<b>Cash flows from investing activities</b>		
Expenditures for property and equipment	(426)	(659)
Costs incurred in connection with patents	(212)	(332)
Net cash used in investing activities	(638)	(991)
<b>Cash flows from financing activities</b>		
Proceeds related to stock based compensation plans	4,279	365
Proceeds from the issuance of long-term debt	7,885	3,500
Payments on long-term debt	(1,935)	(597)
Net cash provided by financing activities	10,229	3,268
Net change in cash and cash equivalents	3,399	(1,177)
<b>Cash and cash equivalents</b>		
Beginning of period	21,159	23,717
End of period	\$ 24,558	\$ 22,540

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

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**CARDIOVASCULAR SYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(For the six months ended December 31, 2011 and 2010)**

**(dollars in thousands, except per share and share amounts)**

**(unaudited)**

**1. Business Overview**

***Company Description***

Cardiovascular Systems, Inc. was incorporated as Replidyne, Inc. in Delaware in 2000. On February 25, 2009, Replidyne, Inc. completed its reverse merger with Cardiovascular Systems, Inc., a Minnesota corporation incorporated in 1989 ( CSI-MN ), in accordance with the terms of the Agreement and Plan of Merger and Reorganization, dated as of November 3, 2008 (the Merger Agreement ). Pursuant to the Merger Agreement, CSI-MN continued after the merger as the surviving corporation and a wholly-owned subsidiary of Replidyne. At the effective time of the merger, Replidyne, Inc. changed its name to Cardiovascular Systems, Inc. ( CSI ) and CSI-MN merged with and into CSI, with CSI continuing after the merger as the surviving corporation.

The Company develops, manufactures and markets devices for the treatment of vascular diseases. The Company's primary products, the Diamondback 360° PAD System, the Predator 360° PAD System, and the Stealth 360° PAD System, are catheter-based platforms capable of treating a broad range of plaque types in leg arteries both above and below the knee and address many of the limitations associated with existing treatment alternatives. Prior to the merger, Replidyne was a biopharmaceutical company focused on discovering, developing, in-licensing and commercializing innovative anti-infective products.

**2. Summary of Significant Accounting Policies**

***Interim Financial Statements***

The Company has prepared the unaudited interim consolidated financial statements and related unaudited financial information in the footnotes 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 ) for interim financial statements. The year-end consolidated balance sheet was derived from the Company's audited consolidated financial statements, but does not include all disclosures as required by GAAP. These interim consolidated financial statements reflect all adjustments consisting of normal recurring accruals, which, in the opinion of management, are necessary to state fairly the Company's consolidated financial position, the results of its operations and its cash flows for the interim periods. These interim consolidated financial statements should be read in conjunction with the consolidated annual financial statements and the notes thereto included in the Form 10-K filed by the Company with the SEC on September 12, 2011. The nature of the Company's business is such that the results of any interim period may not be indicative of the results to be expected for the entire year.

***Fair Value of Financial Instruments***

The Company has adopted fair value guidance issued by the Financial Accounting Standards Board ( FASB ), which provides a framework for measuring fair value under GAAP and expands disclosures about fair value measurements.

The fair value guidance classifies inputs into the following hierarchy:

*Level 1 Inputs* quoted prices in active markets for identical assets and liabilities

*Level 2 Inputs* observable inputs other than quoted prices in active markets for identical assets and liabilities

*Level 3 Inputs* unobservable inputs





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The following table sets forth the fair value of the Company's financial instruments that were measured on a recurring basis as of December 31, 2011. Assets are measured on a recurring basis if they are remeasured at least annually:

	<b>Level 3 Conversion Option</b>
Balance at June 30, 2011	\$ 925
Issuance of \$1,500 in convertible notes	295
Change in conversion option valuation	(384)
Conversion of \$500 convertible note	(182)
<b>Balance at December 31, 2011</b>	<b>\$ 654</b>

The fair value of the conversion option is related to the loan and security agreement with Partners for Growth (described in Note 4) and has been included in debt conversion option and other assets on the balance sheet. The Monte Carlo option pricing model used to determine the value of the conversion option included various inputs including historical volatility, stock price simulations, and assessed behavior of the Company and Partners for Growth based on those simulations. Based upon these inputs, the Company considers the conversion option to be a Level 3 investment.

As of December 31, 2011, the Company believes that the carrying amounts of its other financial instruments, including accounts receivable, accounts payable and accrued liabilities approximate their fair value due to the short-term maturities of these instruments. The carrying amount of long-term debt approximates fair value based on interest rates currently available for debt with similar terms and maturities.

***Use of Estimates***

The preparation of the Company's consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Stock-Based Compensation***

The Company recognizes stock-based compensation expense in an amount equal to the fair value of share-based payments computed at the date of grant. The fair value of all stock option and restricted stock awards are expensed in the consolidated statements of operations ratably over the related vesting period.

***Revenue Recognition***

The Company sells the majority of its products via direct shipment to hospitals or clinics. The Company recognizes revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the sales price is fixed or determinable; and collectability is reasonably assured. These criteria are met at the time of delivery when the risk of loss and title passes to the customer. The Company records estimated sales returns, discounts and rebates as a reduction of net sales in the same period revenue is recognized.

***Recent Accounting Pronouncements***

In May 2011, the FASB issued guidance to amend the accounting and disclosure requirements on fair value measurements. The new guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the new guidance expands the disclosures on Level 3 inputs by requiring quantitative disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. The new guidance became effective for the Company beginning January 1, 2012. Other than requiring additional disclosures, the Company does not anticipate material impacts on its consolidated financial statements following adoption.

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In June 2011, the FASB issued guidance requiring that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. The new guidance will be effective for the Company beginning July 1, 2012. Other than requiring additional disclosures, the Company does not anticipate material impacts on its consolidated financial statements upon adoption.

**Table of Contents****3. Selected Consolidated Financial Statement Information*****Inventories***

Inventories are stated at the lower of cost or market with cost determined on a first-in, first-out ( FIFO ) method of valuation.

At December 31, 2011 and June 30, 2011, respectively, inventories were comprised of the following:

	December 31, 2011	June 30, 2011
<b>Inventories</b>		
Raw materials	\$ 3,539	\$ 2,705
Work in process	622	640
Finished goods	3,802	2,473
	<b>\$ 7,963</b>	<b>\$ 5,818</b>

**4. Debt*****Loan and Security Agreement with Silicon Valley Bank***

On March 29, 2010, the Company entered into an amended and restated loan and security agreement with Silicon Valley Bank. The agreement was amended on December 27, 2011. The agreement, as amended, includes a \$12,000 term loan and a \$15,000 line of credit. The terms of each of these loans are as follows:

The \$12,000 term loan has an initial interest rate of 8.0%, which can be reduced to 7.0% based on the achievement of positive EBITDA for the trailing six month period. The term loan has a 36 month maturity, with repayment terms that include interest only payments during the first six months, followed by 30 equal principal payments of \$400 plus interest, and a final payment of \$100 due at maturity. This term loan also includes an acceleration provision that requires the Company to pay the entire outstanding balance, plus a penalty ranging from 1.0% to 3.0% of the principal amount, upon prepayment or the occurrence and continuance of an event of default. The balance outstanding on the term loan at December 31, 2011 was \$11,811. The unamortized discount associated with warrants issued to Silicon Valley Bank in connection with the loan and other fees paid to the lender will be amortized over the 36 month maturity period. This transaction is being accounted for as a debt modification.

The \$15,000 line of credit expires March 31, 2014 and has a floating interest rate equal to Silicon Valley Bank's prime rate, plus 2.0%, with an interest rate floor of 6.0%. Interest on borrowings is due monthly and the principal balance is due at maturity. Borrowings on the line of credit are based on (a) 80% of eligible domestic receivables, plus (b) the lesser of 40% of eligible inventory or 25% of eligible domestic receivables or \$2,500, minus (c) to the extent in effect, certain loan reserves as defined in the agreement. Accounts receivable receipts are deposited into a lockbox account in the name of Silicon Valley Bank. The line of credit is subject to non-use fees, annual fees, and cancellation fees. The agreement provides that upon the achievement of certain financial covenants, the amount reducing available borrowings will be zero, however, if certain financial covenants are not met, 75% of the outstanding principal balance of the \$12,000 term loan reduces available borrowings under the line of credit. There was not an outstanding balance on the line of credit at December 31, 2011.

Borrowings from Silicon Valley Bank are secured by all of the Company's assets. The borrowings are subject to prepayment penalties and financial covenants, including maintaining certain liquidity and fixed charge coverage ratios, and certain three-month EBITDA targets. The Company was in compliance with all financial covenants as of December 31, 2011. The agreement also includes subjective acceleration clauses which permit Silicon Valley Bank to accelerate the due date under certain circumstances, including, but not limited to, material adverse effects on the Company's financial status or otherwise. Any non-compliance by the Company under the terms of debt arrangements could result in an event of default under the Silicon Valley Bank loan, which, if not cured, could result in the acceleration of this debt.



**Table of Contents*****Loan and Security Agreement with Partners for Growth***

On April 14, 2010, the Company entered into a loan and security agreement with Partners for Growth III, L.P. (PFG). The agreement, as amended, provides that PFG will make loans to the Company up to \$4,000. The agreement has a maturity date of April 14, 2015. The loans bear interest at a floating per annum rate equal to 2.75% above Silicon Valley Bank's prime rate, and such interest is payable monthly. The principal balance of and any accrued and unpaid interest on any notes are due on the maturity date and may not be prepaid by the Company at any time in whole or in part. On August 23, 2011, the loan and security agreement was amended to provide that PFG will make loans to the Company up to \$5,000. All other terms of the original agreement remain the same. On December 27, 2011, the loan and security agreement, as amended, raises the total amount of indebtedness that the Company may accrue under the term loan portion of the amended and restated loan and security agreement with Silicon Valley Bank, as amended, from \$10,000 to \$12,000.

As of December 31, 2011, PFG has provided the Company the following three loans totaling \$5,000 that are outstanding: (i) a \$3,500 loan dated June 30, 2011 with a conversion price of \$13.64, (ii) a \$500 loan dated August 4, 2011, as amended and restated August 24, 2011, with a conversion price of \$15.30, and (iii) a \$1,000 loan dated August 24, 2011 with a conversion price of \$13.42. At any time prior to the maturity date, PFG may at its option convert any of the outstanding loans into shares of the Company's common stock at the applicable conversion price, which in each case equaled the ten-day volume weighted average price per share of the Company's common stock prior to the issuance date of each note. The Company may also effect at any time a mandatory conversion of amounts, subject to certain terms, conditions and limitations provided in the agreement, including a requirement that the ten-day volume weighted average price of the Company's common stock prior to the date of conversion is at least 15% greater than the conversion price. The Company may reduce the conversion price to a price that represents a 15% discount to the ten-day volume weighted average price of its common stock to satisfy this condition and effect a mandatory conversion. During the six months ended December 31, 2011, PFG, at its option, converted a \$500 loan (at par) into 40,323 shares of the Company's common stock in accordance with the conversion terms set forth in the agreement. The Company has reflected a net expense of \$566 for the six months ended December 31, 2011 as a component of interest and other, net on the accompanying statement of operations, which represents the net effect of (i) the write-off of the conversion option on the converted loan, (ii) the write-off of the unamortized debt premium on the converted loan and (iii) the change in fair value of the conversion options on all outstanding loans. The balance outstanding under the loan and security agreement at December 31, 2011 was \$5,679. The net unamortized premium associated with warrants issued to PFG in connection with the loan, a beneficial conversion feature, and other fees paid to the lender will be amortized over the remaining maturity period.

The loans are secured by certain of the Company's assets, and the agreement contains customary covenants limiting the Company's ability to, among other things, incur debt or liens, make certain investments and loans, effect certain redemptions of and declare and pay certain dividends on its stock, permit or suffer certain change of control transactions, dispose of collateral, or change the nature of its business. In addition, the PFG loan and security agreement contains financial covenants requiring the Company to maintain certain liquidity and fixed charge coverage ratios, and certain three-month EBITDA targets. The Company was in compliance with all financial covenants at December 31, 2011. If the Company does not comply with the various covenants, PFG may, subject to various customary cure rights, decline to provide additional loans, require amortization of the loan over its remaining term, or require the immediate payment of all amounts outstanding under the loan and foreclose on any or all collateral, depending on which financial covenants are not maintained.

As of December 31, 2011, debt maturities were as follows:

Six months ending June 30, 2012	\$
2013	4,800
2014	5,050
2015	7,400
Total	\$ 17,250
Less: Current Maturities	(2,337)
Long-Term Debt (excluding net unamortized premium)	\$ 14,913
Add: Net Unamortized Premium	490
Long-term debt	\$ 15,403



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Interest and other, net, includes the following:

	Three Months		Six Months Ended	
	Ended		December 31,	
	December 31,	December 31,	2011	2010
	2011	2010	2011	2010
Interest expense, net of premium amortization	\$ (279)	\$ (338)	\$ (623)	\$ (803)
Interest income	1	4	2	11
Change in fair value of conversion option	(180)	651	(384)	751
Net write-offs upon conversion (option and unamortized premium)		(275)	(182)	(275)
Other	(18)	(15)	(48)	(31)
Total	\$ (476)	\$ 27	\$ (1,235)	\$ (347)

**6. Stock Options and Restricted Stock Awards**

The Company has a 2007 Equity Incentive Plan (the 2007 Plan), which was assumed from CSI-MN, under which options to purchase common stock and restricted stock awards have been granted to employees, directors and consultants at exercise prices determined by the board of directors; and also in connection with the merger the Company assumed options and restricted stock awards granted by CSI-MN under its 1991 Stock Option Plan (the 1991 Plan) and 2003 Stock Option Plan (the 2003 Plan) (the 2007 Plan, the 1991 Plan and the 2003 Plan collectively, the Plans). The 1991 Plan and 2003 Plan permitted the granting of incentive stock options and nonqualified options. A total of 485,250 shares of common stock were originally reserved for issuance under the 1991 Plan, but with the approval of the 2003 Plan no additional options were granted under it. A total of 2,458,600 shares of common stock were originally reserved for issuance under the 2003 Plan, but with the approval of the 2007 Plan no additional options will be granted under it.

The 2007 Plan originally allowed for the granting of up to 1,941,000 shares of common stock as approved by the board of directors in the form of nonqualified or incentive stock options, restricted stock awards, restricted stock unit awards, performance share awards, performance unit awards or stock appreciation rights to officers, directors, consultants and employees of the Company. The Plan was amended in February 2009 to increase the number of authorized shares to 2,509,969. Generally, options or shares granted under the 2007 Plan expire ten years from the date of grant and vest over three years. The amended 2007 Plan includes a renewal provision whereby the number of shares shall automatically be increased on the first day of each fiscal year ending on July 1, 2017, by the lesser of (i) 970,500 shares, (ii) 5% of the outstanding common shares on such date, or (iii) a lesser amount determined by the board of directors. On July 1, 2011, the number of shares available for grant was increased by 849,353 under the 2007 Plan renewal provision.

All options granted under the Plans become exercisable over periods established at the date of grant. The option exercise price is generally not less than the estimated fair market value of the Company's common stock at the date of grant, as determined by the Company's management and board of directors. In addition, the Company has granted nonqualified stock options to a director outside of the Plans.

All options are fully vested. Vested options must be exercised at or within 90 days of termination to avoid forfeiture. The Company determined the fair value of options using the Black-Scholes option pricing model. The estimated fair value of options, including the effect of estimated forfeitures, was recognized as expense on a straight-line basis over the options' vesting periods.

Stock option activity for the six months ended December 31, 2011 is as follows:

	Number of	Weighted
	Options(a)	Average
		Exercise Price
Options outstanding at June 30, 2011	3,070,999	\$ 10.54
Options exercised	(206,446)	\$ 9.54



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Options forfeited or expired		\$	
Options outstanding at December 31, 2011	2,864,553	\$	10.62

- (a) Includes the effect of options granted, exercised, forfeited or expired from the 1991 Plan, 2003 Plan, 2007 Plan, and options granted outside the stock option plans described above.

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The fair value of each restricted stock award is equal to the fair market value of the Company's common stock at the date of grant. Vesting of restricted stock awards ranges from one to three years. The estimated fair value of restricted stock awards, including the effect of estimated forfeitures, is recognized on a straight-line basis over the restricted stock's vesting period. Restricted stock award activity for the six months ended December 31, 2011 is as follows:

	Number of Shares	Weighted Average Fair Value
Restricted stock awards outstanding at June 30, 2011	1,198,207	\$ 6.39
Restricted stock awards granted	464,128	\$ 12.87
Restricted stock awards forfeited	(118,598)	\$ 7.12
Restricted stock awards vested	(410,180)	\$ 13.73
Restricted stock awards outstanding at December 31, 2011	1,133,557	\$ 8.85

**7. Texas Production Facility**

Effective on September 9, 2009, the Company entered into an agreement with the Pearland Economic Development Corporation (the "PEDC") for the construction and lease of an approximately 46,000 square foot production facility located in Pearland, Texas. The facility primarily serves as an additional manufacturing location for the Company.

The lease agreement provides that the PEDC will lease the facility and the land immediately surrounding the facility to the Company for an initial term of ten years, which began April 1, 2010. Monthly fixed rent payments are \$35 for each of the first five years of the initial term and \$38 for each of the last five years of the initial term. The Company is also responsible for paying the taxes and operating expenses related to the facility. The lease has been classified as an operating lease for financial statement purposes. Upon an event of default under the agreement, the Company will be liable for the difference between the balance of the rent owed for the remainder of the term and the fair market rental value of the leased premises for such period.

The Company has the option to renew the lease for up to two additional periods of five years each. If the Company elects to exercise one or both of these options, the rent for such extended terms will be set at the prevailing market rental rates at such times, as determined in the agreement. After the commencement date and until shortly before the tenth anniversary of the commencement date, the Company will have the option to purchase all, but not less than all, of the leased premises at fair market value, as determined in the agreement. Further, within six years of the commencement date and subject to certain conditions, the Company has options to cause the PEDC to make two additions or expansions to the facility of a minimum of 34,000 and 45,000 square feet each.

The Company and the PEDC previously entered into a Corporate Job Creation Agreement dated June 17, 2009 (the "Job Creation Agreement"). The Job Creation Agreement provided the Company with \$2,975 in net cash incentive funds. The Company believes it will be able to comply with the conditions specified in the Job Creation Agreement. The PEDC will provide the Company with an additional \$1,700 of net cash incentive funds in the following amounts and upon achievement of the following milestones:

\$1,020, upon the hiring of the 75<sup>th</sup> full-time employee at the facility; and

\$680, upon the hiring of the 125<sup>th</sup> full-time employee at the facility.

In order to retain all of the cash incentives, beginning one year and 90 days after the commencement date, the Company must not have a planned reduction in the number of employees, resulting in fewer than 25 full-time employees at the facility for more than 120 consecutive days. Failure to meet this requirement will result in an obligation to make reimbursement payments to the PEDC as outlined in the agreement. The Company will not have any reimbursement requirements after 60 months from the effective date of the agreement. As of December 31, 2011, the Company was in compliance with all minimum requirements under the agreement.

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The Job Creation Agreement also provides the Company with a net \$1,275 award, of which \$510 will be funded by a grant from the State of Texas for which the Company has applied through the Texas Enterprise Fund program. As of December 31, 2011, \$340 has been received and the remaining \$170 will be provided upon the hiring of the 55<sup>th</sup> full-time employee at the facility. The PEDC has committed, by resolution, to guarantee the award and will make payment to the Company for the remaining \$765. As of December 31, 2011, \$510 has been received. The grant from the State of Texas is subject to reimbursement if the Company fails to meet certain job creation targets through 2014 and maintain these positions through 2020.

The Company has presented the net cash incentive funds as a current and long-term liability on the balance sheet. The liabilities will be reduced over a 60 month period and recorded as an offset to expenditures incurred using a systematic methodology that is intended to reduce the majority of the liabilities in the first 24 months of the agreement. As of December 31, 2011, \$2,749 in cumulative expenses has reduced the deferred grant incentive liabilities, resulting in a remaining current liability of \$995 and long-term liability of \$336.

**Table of Contents****8. Commitment and Contingencies****Michael Kallok Claim**

On July 18, 2011, the Company received a demand letter from legal counsel for Michael Kallok, a former officer, director and consultant to the Company, claiming that Mr. Kallok is entitled to 42,594 shares of the Company's common stock or, alternatively, the value of those shares as of July 15, 2011, which was \$611. Mr. Kallok asserts that the Company improperly deemed such shares forfeited under a restricted stock agreement with Mr. Kallok. This matter is proceeding to arbitration.

The Company is defending this claim vigorously, and believes that an adverse outcome of this dispute would not have a materially adverse effect on the Company's business, operations, cash flows or financial condition. The Company has not recognized any expense related to the settlement of this matter as it believes an adverse outcome of this action is not probable.

**9. Earnings Per Share**

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
<b>Numerator</b>				
Net loss	(4,135)	\$ (1,990)	\$ (7,994)	\$ (6,258)
<b>Denominator</b>				
Weighted average common shares basic	17,781,326	15,827,046	17,634,134	15,598,101
Effect of dilutive stock options and warrants (a)(b)(c)				
Weighted average common shares outstanding diluted	17,781,326	15,827,046	17,634,134	15,598,101
Net loss per common share basic and diluted	\$ (0.23)	\$ (0.13)	\$ (0.45)	\$ (0.40)

- (a) At December 31, 2011 and 2010, 2,438,784 and 3,211,425 warrants, respectively, were outstanding. The effect of the shares that would be issued upon exercise of these warrants has been excluded from the calculation of diluted loss per share because those shares are anti-dilutive.
- (b) At December 31, 2011 and 2010, 2,864,553 and 3,267,876 stock options, respectively, were outstanding. The effect of the shares that would be issued upon exercise of these options has been excluded from the calculation of diluted loss per share because those shares are anti-dilutive.
- (c) At December 31, 2011 and 2010, 363,794 and 362,318 additional shares of common stock are issuable upon the conversion of outstanding convertible debt agreements. The effect of the shares that would be issued upon conversion of these debt agreements has been excluded from the calculation of diluted loss per share because those shares are anti-dilutive.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes appearing under Item 1 of Part I. Some of the information contained in this discussion and analysis or set forth elsewhere in this quarterly report, including information with respect to our plans and strategy for our business and expected financial results, includes forward-looking statements that involve risks and uncertainties. You should review the Risk Factors discussed in our Form 10-K for the year ended June 30, 2011 for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

**OVERVIEW**

We are a medical device company focused on developing and commercializing interventional treatment systems for vascular disease. Our primary products, the Diamondback 360° PAD System (the Diamondback 360°), the Diamondback Predator 360° PAD System (the Predator 360°), and the Stealth 360° PAD System (the Stealth 360°) are catheter-based platforms capable of treating a broad range of plaque types in leg arteries both above and below the knee and address many of the limitations associated with existing treatment alternatives. We also are pursuing approval of our products for coronary use. We refer to the Diamondback 360°, the Predator 360°, and the Stealth 360° collectively in this report as the PAD Systems.

We were incorporated as Replidyne, Inc. in Delaware in 2000. On February 25, 2009, Replidyne, Inc. completed its business combination with Cardiovascular Systems, Inc., a Minnesota corporation (CSI-MN), in accordance with the terms of the Agreement and Plan of Merger and Reorganization, dated as of November 3, 2008 (the Merger Agreement). Pursuant to the Merger Agreement, CSI-MN continued after the merger as the surviving corporation and a wholly-owned subsidiary of Replidyne. Replidyne changed its name to Cardiovascular Systems, Inc. (CSI) and CSI-MN merged with and into CSI, with CSI continuing after the merger as the surviving corporation. These transactions are referred to herein as the merger. Replidyne was a biopharmaceutical company focused on discovering, developing, in-licensing and commercializing anti-infective products.

At the closing of the merger, Replidyne's net assets, as calculated pursuant to the terms of the Merger Agreement, were approximately \$36.6 million as adjusted. As of immediately following the effective time of the merger, former CSI stockholders owned approximately 80.2% of the outstanding common stock of the combined company, and Replidyne stockholders owned approximately 19.8% of the outstanding common stock of the combined company.

CSI was incorporated in Minnesota in 1989. From 1989 to 1997, we engaged in research and development on several different product concepts that were later abandoned. Since 1997, we have devoted substantially all of our resources to the development of the PAD Systems.

From 2003 to 2005, we conducted numerous bench and animal tests in preparation for application submissions to the FDA. We initially focused our testing on providing a solution for coronary in-stent restenosis, but later changed the focus to peripheral artery disease, or PAD. In 2006, we obtained an investigational device exemption from the FDA to conduct our pivotal OASIS clinical trial, which was completed in January 2007. The OASIS clinical trial was a prospective 20-center study that involved 124 patients with 201 lesions.

In August 2007, the FDA granted us 510(k) clearance for the use of the Diamondback 360° as a therapy in patients with PAD. We commenced commercial introduction of the Diamondback 360° in the United States in September 2007. We were granted 510(k) clearance of the Predator 360° in March 2009 and Stealth 360° in March 2011. We commenced a limited market release of the Stealth 360° following this 510(k) clearance and plan to begin a broader commercial launch in the second half of fiscal 2012. We market the PAD Systems in the United States through a direct sales force and expend significant capital on our sales and marketing efforts to expand our customer base and utilization per customer. We assemble at our facilities the saline infusion pump used with our Stealth 360° product and the single-use catheter used in the PAD Systems with components purchased from third-party suppliers, as well as with components manufactured in-house. The control unit and guidewires are purchased from third-party suppliers.

As of December 31, 2011, we had an accumulated deficit of \$170.4 million. We expect our losses to continue but generally decline as revenue grows from continued commercialization activities, development of additional product enhancements, accumulation of clinical data on our products, and further regulatory submissions. To date, we have financed our operations primarily from the issuance of common and preferred stock, convertible promissory notes, and debt.

**Table of Contents****CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT JUDGMENTS AND ESTIMATES**

Our management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our consolidated financial statements requires us to make estimates, assumptions and judgments that affect amounts reported in those statements. Our estimates, assumptions and judgments, including those related to revenue recognition, allowance for doubtful accounts, excess and obsolete inventory, debt conversion option, and stock-based compensation are updated as appropriate at least quarterly. We use authoritative pronouncements, our technical accounting knowledge, cumulative business experience, judgment and other factors in the selection and application of our accounting policies. While we believe that the estimates, assumptions and judgments that we use in preparing our consolidated financial statements are appropriate, these estimates, assumptions and judgments are subject to factors and uncertainties regarding their outcome. Therefore, actual results may materially differ from these estimates.

Some of our significant accounting policies require us to make subjective or complex judgments or estimates. An accounting estimate is considered to be critical if it meets both of the following criteria: (1) the estimate requires assumptions about matters that are highly uncertain at the time the accounting estimate is made, and (2) different estimates that reasonably could have been used, or changes in the estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of our financial condition, results of operations, or cash flows.

**RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, our results of operations expressed as dollar amounts, and, for certain line items, the changes between the specified periods expressed as percent increases or decreases:

(\$ in thousands)	Three Months Ended December 31,			Six Months Ended December 31,		
	2011	2010	Percent Change	2011	2010	Percent Change
Revenues	\$ 19,718	\$ 18,756	5.1%	\$ 38,378	\$ 36,921	3.9%
Cost of goods sold	4,560	3,972	14.8	8,906	8,113	9.8
Gross profit	15,158	14,784	2.5	29,472	28,808	2.3
Expenses:						
Selling, general and administrative	15,733	14,687	7.1	31,083	30,183	3.0
Research and development	3,084	2,114	45.9	5,148	4,536	13.5
Total expenses	18,817	16,801	12.0	36,231	34,719	4.4
Loss from operations	(3,659)	(2,017)	81.4	(6,759)	(5,911)	14.3
Interest and other, net	(476)	27	1862.0	(1,235)	(347)	256.0
Net loss	\$ (4,135)	\$ (1,990)	107.8	\$ (7,994)	\$ (6,258)	27.7

**Comparison of Three Months Ended December 31, 2011 with Three Months Ended December 31, 2010**

*Revenues.* Revenues increased by \$962,000, or 5.1%, from \$18.8 million for the three months ended December 31, 2010 to \$19.7 million for the three months ended December 31, 2011. This increase was attributable to a \$1.1 million, or 6.7%, increase in revenues generated from the sale of PAD Systems, primarily from increased average selling prices. This increase was partially offset by the decrease in supplemental product and other revenue of \$135,000, or 5.7%, primarily from the termination of a distribution agreement. Supplemental product and other revenues include our Viper product line, wires, freight & handling and distribution partner products.

Currently, all of our revenues are in the United States; however, we may potentially sell internationally in the future. We expect our revenue to increase as we continue to increase the number of physicians using the devices, increase the usage per physician, introduce new and improved

products, and generate clinical data.

*Cost of Goods Sold.* Cost of goods sold increased by \$588,000, or 14.8%, from \$4.0 million for the three months ended December 31, 2010 to \$4.6 million for the three months ended December 31, 2011. Cost of goods sold represents the cost of materials, labor and overhead for single-use catheters, guidewires, control units, and other ancillary products. The increase was due to a higher mix of Stealth 360° sales which currently carry higher unit costs due to limited initial component purchasing volumes. Also, the ramp up of our second manufacturing facility in Texas for additional production capacity has temporarily increased production

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costs. Cost of goods sold for the three months ended December 31, 2011 and 2010 includes \$79,000 and \$91,000 respectively, for stock-based compensation. We expect that the gross margin will stay fairly consistent through the end of this fiscal year, and then gradually improve as Stealth 360° production increases and the Texas facility becomes more fully utilized. Quarterly fluctuations could occur based on timing of new product introductions, sales mix, pricing changes, or other unanticipated circumstances.

*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses increased by \$1.0 million, or 7.1%, from \$14.7 million for the three months ended December 31, 2010 to \$15.7 million for the three months ended December 31, 2011. The primary reason for the increase was additional expenses relating to the building of our sales organization, and payments related to disputed amounts with a former vendor. Selling, general and administrative expenses for the three months ended December 31, 2011 and 2010 includes \$1.1 million and \$1.5 million, respectively, for stock-based compensation. We expect our selling, general and administrative expenses to increase in the future due primarily to the costs associated with expanding our sales and marketing organization to further commercialize our products, but at a rate less than revenue growth on an annual basis. Fluctuations from these expectations could occur based on the timing of expenditures.

*Research and Development Expenses.* Research and development expenses increased by \$970,000, or 45.9%, from \$2.1 million for the three months ended December 31, 2010 to \$3.1 million for the three months ended December 31, 2011. Research and development expenses relate to specific projects to improve our products or expand into new markets, such as the development of new versions of the PAD Systems, shaft designs, crown designs, and PAD and coronary clinical trials. The increase was related to advancing the Orbit II clinical trial, along with prior year expenses being reduced by the receipt of a \$488,000 grant under the Qualifying Therapeutic Discovery Project program. Research and development expenses for the three months ended December 31, 2011 and 2010 includes \$123,000 and \$346,000, respectively, for stock-based compensation. As we continue to expand our product portfolio within the market for the treatment of peripheral arteries and leverage our core technology into the coronary market, we generally expect to incur increased quarterly research and development expenses throughout the remainder of fiscal year 2012, as compared to the three months ended December 31, 2011. Fluctuations from these expectations could occur based on the number of projects and studies and the timing of expenditures.

*Interest and Other, net.* Interest and other expense increased by \$503,000, from income of \$27,000 for the three months ended December 31, 2010 to expense of \$476,000 for the three months ended December 31, 2011. This increase in expense was primarily due to \$180,000 of expense from conversion and valuation changes of our convertible debt, compared to income of \$376,000 in the prior year.

***Comparison of Six Months Ended December 31, 2011 with Six Months Ended December 31, 2010***

*Revenues.* Revenues increased by \$1.5 million, or 3.9%, from \$36.9 million for the six months ended December 31, 2010 to \$38.4 million for the six months ended December 31, 2011. This increase was attributable to a \$1.5 million, or 3.9%, increase in revenue generated from the sale of PAD Systems, primarily from increased average selling prices. Supplemental product and other revenues slightly declined by \$125,000, or 2.8%, from \$4.5 million for the six months ended December 31, 2010, to \$4.3 million for the six months ended December 31, 2011, primarily from the termination of a distribution agreement. Supplemental product and other revenues include our Viper product line, wires, freight & handling and distribution partner products.

*Cost of Goods Sold.* Cost of goods sold increased by \$793,000, or 9.8%, from \$8.1 million for the six months ended December 31, 2010 to \$8.9 million for the six months ended December 31, 2011. Cost of goods sold represents the cost of materials, labor and overhead for single-use catheters, guidewires, control units, and other ancillary products. The increase was due to a higher mix of Stealth 360° sales which currently carry higher unit costs due to limited initial component purchasing volumes. Also, the ramp up of our second manufacturing facility in Texas for additional production capacity has temporarily increased production costs. Cost of goods sold for the six months ended December 31, 2011 and 2010 includes \$157,000 and \$194,000, respectively, for stock-based compensation.

*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses increased by \$900,000, or 3.0%, from \$30.2 million for the six months ended December 31, 2010 to \$31.1 million for the six months ended December 31, 2011. The primary reason for the increase was additional expenses relating to the building of our sales organization, and payments related to disputed amounts with a former vendor. Selling, general and administrative expenses for the six months ended December 31, 2011 and 2010 includes \$2.3 million and \$3.1 million, respectively, for stock-based compensation.



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*Research and Development Expenses.* Research and development expenses increased by \$612,000, or 13.5%, from \$4.5 million for the six months ended December 31, 2010 to \$5.1 million for the six months ended December 31, 2011. Research and development expenses relate to specific projects to improve our product or expand into new markets, such as the development of new versions of the PAD Systems, shaft designs, crown designs, and PAD and coronary clinical trials. The increase was related to investments in advancing the Orbit II clinical trial, along with prior year expenses being reduced by the receipt of a \$488,000 grant under the Qualifying Therapeutic Discovery Project program. Research and development expenses for the six months ended December 31, 2011 and 2010 includes \$677,000 and \$661,000, respectively, for stock-based compensation.

*Interest and Other, net.* Interest and other expense, net increased by \$888,000, from \$347,000 for the six months ended December 31, 2010 to \$1.2 million for the six months ended December 31, 2011. This increase in expense was primarily due to \$566,000 of expense from conversion and valuation changes of our convertible debt, compared to income of \$476,000 in the prior year.

**NON-GAAP FINANCIAL INFORMATION**

To supplement our consolidated financial statements prepared in accordance with GAAP, our management uses a non-GAAP financial measure referred to as Adjusted EBITDA. The following table sets forth, for the periods indicated, a reconciliation of Adjusted EBITDA to the most comparable U.S. GAAP measure expressed as dollar amounts (in thousands):

	<b>Six Months Ended December 31,</b>	
	<b>2011</b>	<b>2010</b>
Loss from operations	\$ (6,759)	\$ (5,911)
Add: Stock-based compensation	2,719	3,905
Add: Depreciation and amortization	448	337
Adjusted EBITDA	\$ (3,592)	\$ (1,669)

The decline in Adjusted EBITDA of \$1.9 million, or 115.2%, is primarily the result of the \$848,000, or 14.3%, increase in loss from operations. The loss from operations was significantly impacted by the increase in operating expenses while only being partially offset by the increase in gross profit.

Adjusted EBITDA was also impacted by a decrease in stock-based compensation and increase in depreciation and amortization. Stock-based compensation decreased \$1.2 million, or 30.4%, from \$3.9 million for the six months ended December 31, 2010 to \$2.7 million for the year ended December 30, 2011. Stock-based compensation decreased as a result of fewer grants, more forfeiture credits and shares vesting. Depreciation and amortization increased as a result of additional investment in capital equipment during the six months ended December 31, 2011 as compared to the six months ended December 31, 2010.

***Use and Economic Substance of Non-GAAP Financial Measures Used and Usefulness of Such Non-GAAP Financial Measures to Investors***

We use Adjusted EBITDA as a supplemental measure of performance and believe this measure facilitates operating performance comparisons from period to period and company to company by factoring out potential differences caused by depreciation and amortization expense and non-cash charges such as stock-based compensation. Our management uses Adjusted EBITDA to analyze the underlying trends in our business, assess the performance of our core operations, establish operational goals and forecasts that are used to allocate resources and evaluate our performance period over period and in relation to our competitors' operating results. Additionally, our management is partially evaluated on the basis of Adjusted EBITDA when determining achievement of their incentive compensation performance targets.

We believe that presenting Adjusted EBITDA provides investors greater transparency to the information used by our management for its financial and operational decision-making and allows investors to see our results through the eyes of management. We also believe that providing this information better enables our investors to understand our operating performance and evaluate the methodology used by our management to evaluate and measure such performance.

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The following is an explanation of each of the items that management excluded from Adjusted EBITDA and the reasons for excluding each of these individual items:

*Stock-based compensation expense.* We exclude stock-based compensation expense from our non-GAAP financial measures primarily because such expense, while constituting an ongoing and recurring expense, is not an expense that requires cash settlement. Our management also believes that excluding this item from our non-GAAP results is useful to investors to understand the application of stock-based compensation guidance and its impact on our operational performance, liquidity and ability to make additional investments in the Company, and it allows for greater transparency to certain line items in our financial statements.

*Depreciation and amortization expense.* We exclude depreciation and amortization expense from our non-GAAP financial measures primarily because such expenses, while constituting ongoing and recurring expenses, are not expenses that require cash settlement and are not used by our management to assess the core profitability of our business operations. Our management also believes that excluding these items from our non-GAAP results is useful to investors to understand our operational performance, liquidity and ability to make additional investments in the Company.

### ***Material Limitations Associated with the Use of Non-GAAP Financial Measures and Manner in which We Compensate for these Limitations***

Non-GAAP financial measures have limitations as analytical tools and should not be considered in isolation or as a substitute for our financial results prepared in accordance with GAAP. Some of the limitations associated with our use of these non-GAAP financial measures are:

Items such as stock-based compensation do not directly affect our cash flow position; however, such items reflect economic costs to us and are not reflected in our Adjusted EBITDA and therefore these non-GAAP measures do not reflect the full economic effect of these items.

Non-GAAP financial measures are not based on any comprehensive set of accounting rules or principles and therefore other companies may calculate similarly titled non-GAAP financial measures differently than we do, limiting the usefulness of those measures for comparative purposes.

Our management exercises judgment in determining which types of charges or other items should be excluded from the non-GAAP financial measures we use.

We compensate for these limitations by relying primarily upon our GAAP results and using non-GAAP financial measures only supplementally.

## **LIQUIDITY AND CAPITAL RESOURCES**

We had cash and cash equivalents of \$24.6 million and \$21.2 million at December 31, 2011 and June 30, 2011, respectively. During the six months ended December 31, 2011, net cash used in operations was \$6.2 million. As of December 31, 2011, we had an accumulated deficit of \$170.4 million. We have historically funded our operating losses primarily from the issuance of common and preferred stock, convertible promissory notes, and debt.

### ***Loan and Security Agreement with Silicon Valley Bank***

On March 29, 2010, we entered into an amended and restated loan and security agreement with Silicon Valley Bank. The agreement was amended on December 27, 2011. The agreement, as amended, includes a \$12.0 million term loan and a \$15.0 million line of credit. The terms of each of these loans are as follows:

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The \$12.0 million term loan has an initial interest rate of 8.0%, which can be reduced to 7.0% based on the achievement of positive EBITDA for the trailing six month period. The term loan has a 36 month maturity, with repayment terms that include interest only payments during the first six months, followed by 30 equal principal payments of \$400,000 plus interest, and a final payment of \$100,000 due at maturity. This term loan also includes an acceleration provision that requires us to pay the entire outstanding balance, plus a penalty ranging from 1.0% to 3.0% of the principal amount, upon prepayment or the occurrence and continuance of an event of default. The balance outstanding on the term loan at December 31, 2011 was \$11.8 million. The unamortized discount associated with warrants issued to Silicon Valley Bank in connection with the loan and other fees paid to the lender will be amortized over the 36 month maturity period. This transaction is being accounted for as a debt modification.

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The \$15.0 million line of credit expires on March 31, 2014 and has a floating interest rate equal to Silicon Valley Bank's prime rate, plus 2.0%, with an interest rate floor of 6.0%. Interest on borrowings is due monthly and the principal balance is due at maturity. Borrowings on the line of credit are based on (a) 80% of eligible domestic receivables, plus (b) the lesser of 40% of eligible inventory or 25% of eligible domestic receivables or \$2.5 million, minus (c) to the extent in effect, certain loan reserves as defined in the agreement. Accounts receivable receipts are deposited into a lockbox account in the name of Silicon Valley Bank. The line of credit is subject to non-use fees, annual fees, and cancellation fees. The agreement provides that upon the achievement of certain financial covenants, the amount reducing available borrowings will be zero, however, if certain financial covenants are not met, 75% of the outstanding principal balance of the \$12.0 million term loan reduces available borrowings under the line of credit. There was not an outstanding balance on the line of credit at December 31, 2011.

Borrowings from Silicon Valley Bank are secured by all of our assets. The borrowings are subject to prepayment penalties and financial covenants, including maintaining certain liquidity and fixed charge coverage ratios, and certain three-month EBITDA targets. We were in compliance with all financial covenants as of December 31, 2011. The agreement also includes subjective acceleration clauses which permit Silicon Valley Bank to accelerate the due date under certain circumstances, including, but not limited to, material adverse effects on our financial status or otherwise. Any non-compliance by us under the terms of debt arrangements could result in an event of default under the Silicon Valley Bank loan, which, if not cured, could result in the acceleration of this debt.

In connection with and as additional consideration for entering into the amendment to the amended and restated loan agreement with Silicon Valley Bank on December 27, 2011, we issued a warrant to purchase 12,760 shares of our common stock to Silicon Valley Bank, which warrant Silicon Valley Bank immediately transferred to its parent company, SVB Financial Group. The warrant's exercise price was set at \$9.796 per share, which price was based on the five-day average closing share price of the Company's common stock prior to the date of the amendment. The warrant expires on the tenth anniversary of the issue date, subject to earlier expiration in accordance with its terms. In connection with entering into the amendment to the loan and security agreement with Partners for Growth III, L.P., as amended, on December 27, 2011, we issued one warrant to purchase 24,900 shares of our common stock to Silicon Valley Bank. The warrant expires on the fifth anniversary of the issue date, subject to earlier expiration in accordance with its terms, and the exercise price for the warrant was set at \$9.33 per share.

***Loan and Security Agreement with Partners for Growth***

On April 14, 2010, we entered into a loan and security agreement with Partners for Growth III, L.P. (PFG). The agreement provides that PFG will make loans to us up to \$4.0 million. The agreement has a maturity date of April 14, 2015. The loans bear interest at a floating per annum rate equal to 2.75% above Silicon Valley Bank's prime rate, and such interest is payable monthly. The principal balance of and any accrued and unpaid interest on any notes are due on the maturity date and may not be prepaid by us at any time in whole or in part. On August 23, 2011, the loan and security agreement was amended to provide that PFG will make loans to us up to \$5.0 million. All other terms of the original agreement remain the same. On December 27, 2011, the loan and security agreement, as amended, was amended to raise the total amount of indebtedness that the Company may accrue under the term loan portion of the amended and restated loan and security agreement with Silicon Valley Bank, as amended, from \$10.0 million to \$12.0 million.

As of December 31, 2011, PFG has provided us the following three loans totaling \$5.0 million that are outstanding: (i) a \$3.5 million loan dated June 30, 2011 with a conversion price of \$13.64, (ii) a \$500,000 loan dated August 4, 2011, as amended and restated August 24, 2011, with a conversion price of \$15.30, and (iii) a \$1.0 million loan dated August 24, 2011 with a conversion price of \$13.42. At any time prior to the maturity date, PFG may at its option convert any of the outstanding loans into shares of our common stock at the applicable conversion price, which in each case equaled the ten-day volume weighted average price per share of our common stock prior to the issuance date of each note. We may also effect at any time a mandatory conversion of amounts, subject to certain terms, conditions and limitations provided in the agreement, including a requirement that the ten-day volume weighted average price of our common stock prior to the date of conversion is at least 15% greater than the conversion price. We may reduce the conversion price to a price that represents a 15% discount to the ten-day volume weighted average price of our common stock to satisfy this condition and effect a mandatory conversion. During the six months ended December 31, 2011, PFG, at its option, converted a \$500,000 loan (at par) into 40,323 shares of our common stock in accordance with the conversion terms set forth in the agreement. We have reflected a net expense of \$566,000 for the six months ended December 31, 2011 as a component of interest and other, net on the accompanying statement of operations, which represents the net effect of (i) the write-off of the conversion option on the converted loan, (ii) the write-off of the unamortized debt premium on the converted loan and (iii) the change in fair value of the

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conversion options on all outstanding loans. The balance outstanding under the loan and security agreement at December 31, 2011 was \$5.7 million. The net unamortized premium associated with warrants issued to PFG in connection with the loan, a beneficial conversion feature, and other fees paid to the lender will be amortized over the remaining maturity period.

The loans are secured by certain of our assets, and the agreement contains customary covenants limiting the our ability to, among other things, incur debt or liens, make certain investments and loans, effect certain redemptions of and declare and pay certain dividends on its stock, permit or suffer certain change of control transactions, dispose of collateral, or change the nature of its business. In addition, the PFG loan and security agreement contains financial covenants requiring us to maintain certain liquidity and fixed charge coverage ratios, and certain three-month EBITDA targets. We were in compliance with all financial covenants at December 31, 2011. If we do not comply with the various covenants, PFG may, subject to various customary cure rights, decline to provide additional loans, require amortization of the loan over its remaining term, or require the immediate payment of all amounts outstanding under the loan and foreclose on any or all collateral, depending on which financial covenants are not maintained.

In connection with and as additional consideration for entering into the amendment to the loan and security agreement with PFG, as amended, on December 27, 2011, we issued one warrant to purchase 23,151 shares of our common stock to PFG and one warrant to purchase 3,396 shares of our common stock to PFG Equity Investors, LLC, an affiliate of PFG. Each warrant expires on the fifth anniversary of the issue date, subject to earlier expiration in accordance with its terms, and the exercise price for each of the warrants was set at \$9.33 per share.

*Cash and Cash Equivalents.* Cash and cash equivalents were \$24.6 million at December 31, 2011 and \$21.2 million at June 30, 2011. The increase is primarily attributable to net cash provided by financing activities during the six months ended December 31, 2011.

*Operating Activities.* Net cash used in operating activities was \$6.2 million and \$3.5 million for the six months ended December 31, 2011 and 2010, respectively. For the six months ended December 31, 2011 and 2010, we had a net loss of \$8.0 million and \$6.3 million, respectively. Significant adjustments to reconcile net loss to net cash used in operations and changes in working capital during these periods included:

Cash provided by depreciation and amortization of property and equipment of \$448,000 and \$337,000 during the six months ended December 31, 2011 and 2010, respectively. The increase in depreciation and amortization of property and equipment is due to additional investment in property and equipment, primarily at the Texas facility.

Cash provided by (used in) debt conversion and valuation of conversion options of \$566,000 and \$(476,000) during the six months ended December 31, 2011 and 2010, respectively. The increase in cash provided by debt conversion and valuation of conversion options is a result of the change in the fair value of the conversion option, and net write-offs upon conversion.

Cash provided by stock-based compensation of \$2.7 million and \$3.9 million during the six months ended December 31, 2011 and 2010, respectively. The decrease in stock-based compensation is a result of fewer grants, more forfeiture credits and shares vesting.

Cash provided by (used in) accounts receivable of \$824,000 and \$(1.3) million during the six months ended December 31, 2011 and 2010, respectively. For the six months ended December 31, 2011, the cash provided by accounts receivable was primarily due to timing and overall decline in revenues from the three months ended June 30, 2011. For the six months ended December 31, 2010, cash (used in) accounts receivable was primarily due to timing and growth of revenue from the three months ended June 30, 2010, and a receivable of \$510,000 representing additional grants for the Texas facility.

Cash (used in) inventories of \$(2.1) million and \$(2,000) during the six months ended December 31, 2011 and 2010, respectively. For the six months ended December 31, 2011, cash used in inventories was primarily due to the addition of the Stealth 360° product line, and the timing of inventory purchases and sales. For the six months ended December 31, 2010, the low amount of cash used in inventories was primarily due to consistent quarterly sales from the three months ended June 30, 2009 through the three months ended December 31, 2009.

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Cash provided by accounts payable of \$452,000 and \$761,000 during the six months ended December 31, 2011 and 2010, respectively. For the six months ended December 31, 2011 and December 31, 2010, cash provided by accounts payable was due to timing of purchases and vendor payments.

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Cash (used in) accrued expenses and other liabilities of \$(1.1) million and \$(721,000) during the six months ended December 31, 2011 and 2010, respectively. For both periods, cash (used in) accrued expenses and other liabilities were primarily due to amount and timing of payments.

*Investing Activities.* Net cash (used in) investing activities was \$(638,000) and \$(991,000) for the six months ended December 31, 2011 and 2010, respectively. For the six months ended December 31, 2011 and 2010, cash used in investing activities entirely related to the purchase of property and equipment and patents.

*Financing Activities.* Net cash provided by financing activities was \$10.2 million in the six months ended December 31, 2011.

Cash provided by financing activities in this period included:

Exercise of stock options and warrants and stock based compensation plans of \$4.3 million.

Proceeds from long-term debt of \$7.9 million.

Cash (used in) financing activities in this period included:

Payments of long-term debt of \$1.9 million.

*Financing Activities.* Net cash provided by financing activities was \$3.3 million in the six months ended December 31, 2010.

Cash provided by financing activities in this period included:

Exercise of stock options and warrants of \$365,000.

Proceeds from long-term debt of \$3.5 million.

Cash (used in) financing activities in this period included:

Payments of long-term debt of \$597,000.

Our future liquidity and capital requirements will be influenced by numerous factors, including the extent and duration of future operating losses, the level and timing of future sales and expenditures, the results and scope of ongoing research and product development programs, working capital required to support our sales growth, the receipt of and time required to obtain regulatory clearances and approvals, our sales and marketing programs, the continuing acceptance of our products in the marketplace, competing technologies, and market and regulatory developments. As of December 31, 2011, we believe our current cash and cash equivalents and available debt will be sufficient to fund working capital requirements, capital expenditures and operations for at least the next 12 months. We intend to retain any future earnings to support operations and to finance the growth and development of our business, and we do not anticipate paying any dividends in the foreseeable future.

**INFLATION**

We do not believe that inflation has had a material impact on our business and operating results during the periods presented.

**OFF-BALANCE SHEET ARRANGEMENTS**

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Since inception, we have not engaged in any off-balance sheet activities as defined in Item 303(a)(4) of Regulation S-K.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2011, the FASB issued guidance to amend the accounting and disclosure requirements on fair value measurements. The new guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the new guidance expands the disclosures on Level 3 inputs by requiring quantitative



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disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. The new guidance became effective for us beginning January 1, 2012. Other than requiring additional disclosures, we do not anticipate material impacts on our consolidated financial statements following adoption.

In June 2011, the FASB issued guidance requiring that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. The new guidance will be effective for us beginning July 1, 2012. Other than requiring additional disclosures, we do not anticipate material impacts on our consolidated financial statements upon adoption.

## **PRIVATE SECURITIES LITIGATION REFORM ACT**

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. Such forward-looking information is included in this Form 10-Q, including Item 2 of Part I, and in other materials filed or to be filed by the Company with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Company). Forward-looking statements include all statements based on future expectations. This Form 10-Q contains forward-looking statements that involve risks and uncertainties, including approval of our products for coronary use; the future impact of recent accounting pronouncements; expected compliance with the conditions specified in our Job Creation Agreement; expected outcomes and expected impact of litigation; the expected broader commercial launch of the Stealth 360°; our expectation that our losses will continue but generally decline; the possibility of selling our products internationally in the future; our expectation of increased revenue and increased selling, general and administrative expenses; our expectation that gross margin will stay fairly consistent for the remainder of the fiscal year and gradually improve thereafter; our plans to continue to expand our sales and marketing efforts; our expectation that we will incur research and development expenses in future quarters at amounts higher than the rate for the three months ended December 31, 2011; our belief that our current cash and cash equivalents and available debt will be sufficient to fund working capital requirements, capital expenditures and operations for at least the next 12 months; and our expectations regarding retention of earnings and payment of dividends.

In some cases, you can identify forward-looking statements by the following words: anticipate, believe, continue, could, estimate, expect, may, ongoing, plan, potential, predict, project, should, will, would, or the negative of these terms or other comparable terminology. All forward-looking statements contain these words. Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on our management's beliefs and assumptions, which in turn are based on their interpretation of currently available information.

These statements involve known and unknown risks, uncertainties and other factors that may cause our results or our industry's actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. These factors include regulatory developments in the U.S. and foreign countries; FDA clearances and approvals; approval of products for reimbursement and the level of reimbursement; dependence on market growth; the experience of physicians regarding the effectiveness and reliability of the PAD Systems; the reluctance of physicians to accept new products; success of our clinical trials; competition from other devices; the effectiveness of the Stealth 360°; unanticipated developments affecting our estimates regarding expenses, future revenues and capital requirements; the difficulty to successfully manage operating costs; our inability to expand our sales and marketing organization; our actual research and development efforts and needs; our ability to obtain and maintain intellectual property protection for product candidates; our actual financial resources; and general economic conditions. These and additional risks and uncertainties are described more fully in our Form 10-K filed with the SEC on September 12, 2011. Copies of filings made with the SEC are available through the SEC's electronic data gathering analysis and retrieval system (EDGAR) at [www.sec.gov](http://www.sec.gov).

You should read these risk factors and the other cautionary statements made in this Form 10-Q as being applicable to all related forward-looking statements wherever they appear in this Form 10-Q. We cannot assure you that the forward-looking statements in this Form 10-Q will prove to be accurate. Furthermore, if our forward-looking statements prove to be inaccurate, the inaccuracy may be material. You should read this Form 10-Q completely. Other than as required by law, we undertake no obligation to update these forward-looking statements, even though our situation may change in the future.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The primary objective of our investment activities is to preserve our capital for the purpose of funding operations while at the same time maximizing the income we receive from our investments without significantly increasing risk or decreasing availability. To achieve these objectives, our investment policy allows us to maintain a portfolio of cash equivalents and investments in a variety of



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marketable securities, including money market funds, U.S. government securities, and certain bank obligations. Our cash and cash equivalents as of December 31, 2011 include liquid money market accounts. Due to the short-term nature of these investments, we believe that there is no material exposure to interest rate risk.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer, referred to collectively herein as the Certifying Officers, are responsible for establishing and maintaining our disclosure controls and procedures. The Certifying Officers have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2011. Based on that review and evaluation, which included inquiries made to certain other employees of the Company, the Certifying Officers have concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures, as designed and implemented, are effective.

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the three months ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Refer to Part I, Item 3 (Legal Proceedings) of the Company's Annual Report on Form 10-K for the year ended June 30, 2011.

As provided in Part I, Item 3 to our annual report on Form 10-K for the year ended June 30, 2011, the sole heir to the estate of Dr. Leonid Shturman, his wife, Lela Nadirashvili ( Mrs. Shturman ), filed a writ to dismiss our patent lawsuit in Switzerland based on res judicata and collateral estoppel (the First Complaint ). On August 24, 2011, Mrs. Shturman filed a second complaint in federal court seeking a declaration regarding ownership of the patent portfolio that she claims belongs to Dr. Shturman, slander by us of title to patent rights, tortious interference with prospective business relations, breach of settlement contract, and statutory unfair competition (the Second Complaint ). In December 2011, the U.S. District Court in Minnesota (the Court ) dismissed the First and Second Complaints. The Court found that it did not have jurisdiction over the First and Second Complaints and did not address the merits of the claims.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, including the important information in the section entitled Private Securities Litigation Reform Act, you should carefully consider the Risk Factors discussed in our Form 10-K for the year ended June 30, 2011 for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in this report, and materially adversely affect our financial condition or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial might materially adversely affect our actual business, financial condition and/or operating results.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In connection with and as additional consideration for entering into our Modification No. 2 to Loan and Security Agreement with PFG, we issued one five-year warrant to purchase 23,151 shares of our common stock to PFG, one five-year warrant to purchase 3,396 shares of our common stock to PFG Equity Investors, LLC, an affiliate of PFG, and one five-year warrant to purchase 24,900 shares of our common stock to Silicon Valley Bank. The exercise price for each of the warrants was set at \$9.33 per share.

In connection with and as additional consideration for entering into our First Amendment to Loan and Security Agreement (the Amendment ), we issued a ten-year warrant to purchase 12,760 shares of our common stock to Silicon Valley Bank, which warrant Silicon Valley Bank immediately transferred to its parent company, SVB Financial Group. The warrant's exercise price was set at \$9.796 per share, which price was based on the five-day average closing share price of the Company's common stock prior to the date of the Amendment.

Each of the warrants was issued on December 27, 2011 and is filed as an exhibit to this quarterly report on Form 10-Q. We issued the warrants pursuant to Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended. Each of the counterparties represented that it is an accredited investor.

During our fiscal quarter ended December 31, 2011, we had one cashless exercise of unregistered warrants. On October 3, 2011, we issued 1,198 shares of common stock pursuant to the cashless exercise of unregistered warrants to acquire 4,328 shares at an exercise price of \$8.83 per share. The issuance of the shares was exempt from registration by virtue of Section 3(a)(9) of the Securities Act.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

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(a) Exhibits See Exhibit Index on page following signatures

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**SIGNATURES**

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

Dated: February 9, 2012

CARDIOVASCULAR SYSTEMS, INC.

By /s/ David L. Martin  
David L. Martin  
President and Chief Executive Officer  
(Principal Executive Officer)

By /s/ Laurence L. Betterley  
Laurence L. Betterley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

CARDIOVASCULAR SYSTEMS, INC.

FORM 10-Q

<b>Exhibit No.</b>	<b>Description</b>
10.1	First Amendment to Loan and Security Agreement, dated as of December 27, 2011, by and between the Company and Silicon Valley Bank.
10.2	Warrant to Purchase Stock, dated December 27, 2011, issued by the Company to Silicon Valley Bank.
10.3	Warrant, dated December 27, 2011, issued by the Company to Silicon Valley Bank.
10.4	Modification No. 2 to Loan and Security Agreement, dated as of December 27, 2011, by and between the Company and Partners for Growth III, L.P.
10.5	Warrant, dated December 27, 2011, issued by the Company to PFG Equity Investors, LLC.
10.6	Warrant, dated December 27, 2011, issued by the Company to Partners for Growth III, L.P.
10.7*	Fiscal 2012 Executive Officer Bonus Plan.
31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Financial statements from the quarterly report on Form 10-Q of the Company for the quarter ended December 31, 2011, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Cash Flows, and (iv) the Notes to Financial Statements.

\* Management compensatory plan or arrangement