THORATEC CORP
Form 10-Q
August 07, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

x **Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 28, 2014

Or

o **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	**94-2340464**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6035 Stoneridge Drive, Pleasanton, California	**94588**
(Address of principal executive offices)	(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 x No o

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 x No o

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 x	Accelerated filer o
Non-accelerated filer o (Do not check if smaller reporting company)	Smaller reporting company o

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

As of July 25, 2014, the registrant had 56.3 million shares of common stock outstanding.

Table of Contents

THORATEC CORPORATION

TABLE OF CONTENTS

Thoratec, the Thoratec logo, Thoralon, HeartMate, HeartMate II, IVAD, PVAD, and Pocket Controller are registered trademarks or trademarks of Thoratec Corporation, in the United States and/or other jurisdictions.

CentriMag and PediMag are registered trademarks of Thoratec LLC and PediVAS is a registered trademark of Thoratec Switzerland GmbH.

DuraHeart is a registered trademark of Terumo Corporation.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THORATEC CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands)

	June 28, 2014	December 28, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 134,729	$ 139,099
Short-term available-for-sale investments	156,472	166,691
Receivables, net of allowances of $1,976 in 2014 and $2,163 in 2013	68,648	71,418
Inventories	67,367	60,293
Deferred tax assets	15,161	15,161
Income tax receivable	12,353	5,733
Prepaid expenses and other assets	7,335	7,272
Total current assets	462,065	465,667
Property, plant and equipment, net	55,970	55,163
Goodwill	205,955	205,764
Purchased intangible assets, net	32,602	36,403
Long-term available-for-sale investments	4,270	4,234
Other long-term assets	25,385	24,476
Total Assets	$ 786,247	$ 791,707
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 18,239	$ 17,599
Accrued compensation	14,338	22,759
Contingent liabilities, current portion	9,750	6,962
Other accrued liabilities	26,912	27,001
Total current liabilities	69,239	74,321
Long-term deferred tax liability	1,793	2,224
Other long-term liabilities	12,779	12,105
Contingent liabilities, non-current portion (Note 2)	25,198	36,384
Total Liabilities	109,009	125,034
Shareholders equity:		
Common shares: no par, authorized 100,000; issued and outstanding 56,332 in 2014 and 56,904 in 2013		
Additional paid-in-capital	626,501	621,589
Retained earnings	63,969	57,587
Accumulated other comprehensive loss:	(13,232)	(12,503)
Total Shareholders Equity	677,238	666,673
Total Liabilities and Shareholders Equity	$ 786,247	$ 791,707

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Product sales	$ 118,063	$ 130,479	$ 243,760	$ 248,204
Cost of product sales	34,307	41,000	74,333	76,073
Gross profit	83,756	89,479	169,427	172,131
Operating expenses:				
Selling, general and administrative	35,477	34,924	70,978	69,669
Research and development	23,048	21,506	46,387	46,019
Total operating expenses	58,525	56,430	117,365	115,688
Income from operations	25,231	33,049	52,062	56,443
Other income and (expense):				
Interest expense and other	(2)		(2)	(4)
Interest income and other	559	213	806	1,330
Income before income taxes	25,788	33,262	52,866	57,769
Income tax expense	(8,375)	(10,073)	(17,214)	(16,410)
Net income	$ 17,413	$ 23,189	$ 35,652	$ 41,359
Net Income per share:				
Basic	$ 0.31	$ 0.40	$ 0.63	$ 0.72
Diluted	$ 0.30	$ 0.40	$ 0.62	$ 0.71
Shares used to compute income per share:				
Basic	56,723	57,429	56,781	57,457
Diluted	57,188	58,120	57,538	58,398

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

(in thousands)

	Three Months Ended June 28, 2014	Three Months Ended June 29, 2013	Six Months Ended June 28, 2014	Six Months Ended June 29, 2013
Net income	$ 17,413	$ 23,189	$ 35,652	$ 41,359
Unrealized gains (losses) on investments (net of taxes (benefits) of $(2) and $(142) for the three months ended June 28, 2014 and June 29, 2013, respectively, and $(284) and $5 for the six months ended June 28, 2014 and June 29, 2013, respectively)	4	(225)	(1,407)	(7)
Foreign currency translation adjustments	(781)	612	678	(1,676)
Total other comprehensive income (loss)	(777)	387	(729)	(1,683)
Comprehensive income	$ 16,636	$ 23,576	$ 34,923	$ 39,676

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Six Months Ended June 28, 2014	Six Months Ended June 29, 2013
Cash flows from operating activities:		
Net Income	$ 35,652	$ 41,359
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,207	9,175
Investment premium amortization, net	2,176	1,750
Allowance for (reduction in) bad debt	(995)	201
Non-cash interest income (expense) and other	232	(532)
Tax benefit related to stock options	875	1,351
Change in fair value of contingent consideration	(1,436)	
Share-based compensation expense	14,615	13,372
Excess tax benefits from share-based compensation	(989)	(1,424)
Loss on disposal of assets	613	88
Change in net deferred tax liability	(226)	120
Changes in assets and liabilities:		
Receivables	3,697	2,146
Inventories	(8,104)	(19,136)
Other current and non-current assets	559	920
Accounts payable	1,167	(326)
Income taxes, net	(7,410)	(3,807)
Other current and non-current liabilities	(7,799)	(9,160)
Net cash provided by operating activities	40,834	36,097
Cash flows from investing activities:		
Purchases of available-for-sale investments	(86,877)	(71,506)
Sales and maturities of available-for-sale investments	94,232	67,587
Purchases of property, plant and equipment	(5,330)	(5,680)
Long-term restricted cash		(13,000)
Note receivable from Apica (Note 14)	(2,019)	
Net cash provided by (used in) investing activities	6	(22,599)
Cash flows from financing activities:		
Payment of contingent consideration	(6,107)	(4,220)
Proceeds from stock option exercises	2,867	2,893
Proceeds from stock issued under employee stock purchase plan	2,800	2,536
Excess tax benefits from share-based compensation	989	1,424
Repurchase and retirement of common shares	(46,030)	(6,889)
Net cash used in financing activities	(45,481)	(4,256)
Effect of exchange rate changes on cash and cash equivalents	271	(370)
Net increase (decrease) in cash and cash equivalents	(4,370)	8,872
Net cash and cash equivalents at beginning of period	139,099	101,322

Net cash and cash equivalents at end of period	$	134,729	$	110,194
Supplemental disclosure of consolidated cash flow information:				
Cash paid for taxes	$	24,206	$	18,696
Supplemental disclosure of consolidated non-cash investing and financing activities:				
Transfers of equipment from inventory	$	1,012	$	1,152
Repurchases and retirement of common shares through other accrued liabilities	$	2,266	$	
Purchases of property, plant and equipment through accounts payable and accrued liabilities	$	583	$	279

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 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 as of and for the periods presented. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with GAAP, have been condensed or omitted. The accompanying financial statements should be read in conjunction with our fiscal 2013 consolidated financial statements, and the accompanying notes thereto, filed with the SEC in our Annual Report on Form 10-K for the fiscal year ended December 28, 2013 (the 2013 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 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.

Recent Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board issued Accounting Standard Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. The guidance in this ASU supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, and most industry-specific guidance. This ASU also supersedes some cost guidance included in Subtopic 605-35, *Revenue Recognition-Construction-Type and Production-Type Contracts*. The standard will be effective for the Company starting in fiscal 2017. We have not yet evaluated the impact of the adoption of this accounting standard update on our condensed consolidated financial statements.

Note 2. Acquisition

Acquisition of DuraHeart II

On June 30, 2013 (acquisition date), we acquired certain assets (the Purchased Assets) and assumed certain liabilities from Terumo Corporation (Terumo) related to the DuraHeart II Left Ventricular Assist System product line (DuraHeart II) previously under development by Terumo. Under the terms of the acquisition, we made an upfront cash payment to Terumo of $13.0 million, and will be obligated to make potential future milestone payments, based on regulatory approvals and product sales, of up to $43.5 million. Terumo also maintains the right to repurchase the Purchased Assets in the event that we do not fulfill certain conditions at various dates. As part of the agreement, we hired a team of Terumo employees. Additionally, we entered into a distribution partnership with Terumo, in which Terumo will commercialize DuraHeart II in Japan and potentially other parts of Asia, if and when local regulatory approvals are obtained.

We accounted for the DuraHeart II acquisition as a business combination. In connection with the acquisition, we recorded $2.0 million of acquisition-related costs, which were recognized in our consolidated statement of operations in fiscal 2013 within operating expenses. We also recorded $9.9 million of goodwill, equal to the amount by which the purchase consideration exceeded the fair value of the Purchased Assets. This goodwill was allocated to our sole operating segment and is deductible for U.S. income tax purposes. We will be obligated to pay potential post-closing cash milestone payments of $5.5 million and $10.5 million upon Conformité Européene (CE) Mark approval in Europe and U.S. Food and Drug Administration (FDA) approval, respectively, for the DuraHeart II device currently under development (collectively referred to as the regulatory milestones). Additional milestone payments totaling $27.5 million will become payable by us upon reaching various commercial sale milestones after the regulatory approvals are obtained (referred to as the commercial sales milestones). The fair value of the combined contingent consideration due upon achievement of the regulatory milestones and the commercial sales milestones was estimated to be $18.8 million at the acquisition date and has been recorded as a non-current liability, because such contingent consideration is expected to be settled no earlier than 2016.

Table of Contents

Total purchase price consideration was estimated as follows (in thousands):

Cash paid at the acquisition closing date (June 30, 2013)	$	13,000
Estimated fair value of contingent consideration		18,800
Total estimated purchase price	$	31,800

We determined the initial fair value of the contingent consideration in connection with the regulatory and commercial sales milestones using various estimates, including probabilities of success, discount rates and the estimated amount of time until the conditions of the milestone payments are met. This fair value measurement was based on significant inputs not observable in the market, representing a Level 3 measurement within the fair value hierarchy (see Note 3 for more information about fair value measurements). The key assumptions used to determine the fair value of the contingent consideration at the acquisition date in connection with the regulatory milestones included a discount rate and probability-adjusted milestone payment date ranges. The key assumptions used to determine the fair value of contingent consideration at the acquisition date in connection with the commercial sales milestones included a discount rate and probability-weighted expected milestone payment date ranges based on the aggregate number of commercial units sold. The fair value of this contingent consideration is remeasured at the end of each reporting period with the change in fair value recorded within operating expense in our condensed consolidated statements of operations. In the six months ended June 28, 2014, the fair value of the contingent consideration decreased by $3.2 million as a result of changes in the probabilities of possible outcomes, offset by accretion expense associated with the passage of time. The decrease was reported as research and development expense and selling, general and administrative expense totaling $2.2 million and $1.0 million, respectively, in the condensed consolidated statement of operations for the six months ended June 28, 2014.

Purchase Price Allocation as of the acquisition date is summarized as follows (in thousands):

Property, plant and equipment	$	8,900
Identifiable intangible assets:		
Favorable lease contract		600
IPR&D asset		12,400
Goodwill		9,900
Total estimated purchase price consideration		31,800
Less: Contingent consideration		18,800
Cash paid at the acquisition closing	$	13,000

We recorded an IPR&D asset of $12.4 million, which represents an estimate of the fair value of the in-process technology related to the DuraHeart II device. The fair value of the IPR&D asset was determined using the multi-period excess earnings method, which is equal to the present value of the incremental after-tax cash flows attributable to that intangible asset, discounted based on our best estimate of a market participant s after-tax weighted average cost of capital.

We recorded equipment totaling $8.9 million based on the fair value at the acquisition date. Of that amount, $8.1 million is related to certain equipment that is expected to be primarily used in the production of DuraHeart II units in anticipation of future clinical trials and throughout the commercialization of the product. Depreciation will commence upon production of the DuraHeart II units.

The following pro forma information presents the combined results of operations for the six months ended June 29, 2013 as if we had completed the DuraHeart II acquisition at the beginning of 2012. The pro forma financial information is provided for comparative purposes only and is not necessarily indicative of what actual results would have been had the acquisition occurred on the date indicated, nor does it give effect to synergies, cost savings, fair market value adjustments, immaterial depreciation expense and other changes expected to result from the acquisition. Accordingly, the pro forma financial results do not purport to be indicative of condensed consolidated results of operations as of June 29, 2013, for any period ended on June 29, 2013, or for any other future date or period.

		Six months Ended June 29, 2013
Product sales	$	248,204
Income before taxes		42,392
Net income		30,350

Table of Contents

Note 3. Fair Value Measurements

Our financial assets and liabilities carried at fair value are primarily comprised of investments in money market funds, certificates of deposit, municipal and corporate bonds, commercial paper, variable demand notes, asset-backed securities, auction rate securities (ARS), forward contracts, certain investments held as assets under the deferred compensation plan, marketable equity securities and the contingent consideration in connection with acquisitions. The fair value accounting guidance requires that assets and liabilities be carried at fair value and classified in one of the following three categories:

Level 1: Quoted prices in active markets for identical assets or liabilities that we have the ability to access

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data such as quoted prices, interest rates and yield curves

Level 3: Inputs that are unobservable data points that are not corroborated by market data

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 in the period in which the actual event or change in circumstances that caused the transfer occurs. There were no transfers between Level 1, Level 2 and Level 3 during either the first six months of 2014 or first six months of 2013.

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

	Total Fair Value	Level 1	Level 2	Level 3
		(in thousands)		
As of June 28, 2014:				
Cash equivalents:				
Money market funds	$ 87,209	$ 87,209	$	$
Commercial paper	4,100		4,100	
Municipal bonds	1,531		1,531	
Short-term investments:				
Municipal bonds	132,926		132,926	
Asset-backed securities	3,150		3,150	
Corporate bonds	14,698		14,698	
Commercial paper	3,698		3,698	
Certificate of deposit	2,000		2,000	
Prepaid expenses and other assets:				
Foreign exchange contracts	1,134		1,134	
Long-term investments:				

Auction rate securities		4,270					4,270
Other long-term assets:							
Investments included in our deferred compensation plan		2,177				2,177	
Marketable equity securities		2,341		2,341			
Other accrued liabilities:							
Foreign exchange contracts		487				487	
Contingent consideration (current and non-current portions)	$	34,948	$		$		$ 34,948

		Total Fair Value		Level 1		Level 2	Level 3
				(in thousands)			
As of December 28, 2013:							
Cash equivalents:							
Money market funds	$	97,200	$	97,200	$		$
Commercial paper		13,899				13,899	
Short-term investments:							
Municipal bonds		142,486				142,486	
Variable demand notes		6,700				6,700	
Corporate bonds		5,507				5,507	
Commercial paper		9,998				9,998	
Certificate of deposit		2,000				2,000	
Prepaid expenses and other assets:							
Foreign exchange contracts		592				592	
Long-term investments:							
Auction rate securities		4,234					4,234
Other long-term assets:							
Investments included in our deferred compensation plan		1,700				1,700	
Marketable equity securities		4,019		4,019			
Other accrued liabilities:							
Foreign exchange contracts		156				156	
Contingent consideration (current and non-current portions)	$	43,346	$		$		$ 43,346

Table of Contents

Financial assets and liabilities 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 and liabilities include short-term investments, foreign exchange instruments and certain of our deferred compensation plan securities. In addition, Level 2 financial instruments are valued using comparisons to like-kind financial instruments and models that use readily observable market data as their basis.

Financial assets and liabilities 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 and liabilities include the following:

Auction rate securities Due to limited market activity the determination of fair value requires significant judgment or estimation. These available-for-sale debt securities were valued using a discounted cash-flow model over a five-year period based on estimated interest rates, the present value of future principal payments, and interest payments discounted at rates considered to reflect the current market conditions and the credit quality of ARS.

Contingent consideration The fair value of the contingent consideration related to the acquisition of the medical business of Levitronix LLC (Levitronix Medical) in August 2011 requires significant management judgment or estimation and is calculated using the income approach, using various revenue assumptions and applying a probability to each outcome. The fair value of the contingent consideration is remeasured at the end of each reporting period with the change in fair value recorded within operating expense in our condensed consolidated statements of operations. Actual amounts paid may differ from the obligations recorded. The accretion of interest expense was not significant for all periods presented. Refer to Note 2 for a discussion of the fair value of the contingent consideration associated with the DuraHeart II acquisition.

Available-for-sale investments are carried at fair value and are included in the tables above under short- and long-term investments. The aggregate market value, cost basis and gross unrealized gains and losses of available-for-sale investments by major security type are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		
As of June 28, 2014:				
Short-term investments:				
Municipal bonds	$ 132,792	$ 137	$ (3)	$ 132,926
Corporate bonds	14,712	3	(17)	14,698
Commercial paper	3,698			3,698
Asset-backed securities	3,149	1		3,150
Certificate of deposit	2,000			2,000
Total short-term investments	$ 156,351	$ 141	$ (20)	$ 156,472
Long-term investments:				
Auction rate securities	$ 4,900	$	$ (630)	$ 4,270
Other long-term assets:				
Marketable equity securities	2,996		(655)	2,341
Total long-term	$ 7,896	$	$ (1,285)	$ 6,611
As of December 28, 2013:				
Short-term investments:				

Municipal bonds	$	142,321	$	178	$	(13)	$	142,486
Variable demand notes		6,700						6,700
Corporate bonds		5,500		7				5,507
Commercial paper		9,998						9,998
Certificate of deposit		2,000						2,000
Total short-term investments	$	166,519	$	185	$	(13)	$	166,691
Long-term investments:								
Auction rate securities	$	4,900	$		$	(666)	$	4,234
Other long-term assets:								
Marketable equity securities		2,996		1,023				4,019
Total long-term	$	7,896	$	1,023	$	(666)	$	8,253

Table of Contents

Our deferred compensation plan includes our corporate owned life insurance policies and mutual fund investments. The underlying mutual fund investments are deemed trading securities. The mutual fund investments fair value and the cash surrender value of our corporate-owned life insurance policies are classified in the condensed consolidated balance sheets in Other long-term assets. The aggregate value of our deferred compensation plan assets as of June 28, 2014 and December 28, 2013 was $5.9 million and $5.2 million, respectively. The unrealized gain before tax from the change in the value of the deferred compensation plan was not significant during the first six months of 2014 or first six months of 2013.

The amortized cost and fair value of available-for-sale debt investments, by contractual maturity, were as follows as of June 28, 2014:

	Amortized Cost	Fair Value
	(in thousands)	
Maturing within 1 year	$ 121,566	$ 121,646
Maturing after 1 year through 5 years	34,785	34,826
Short-term available-for-sale investments	156,351	156,472
Maturing after 5 years	4,900	4,270
	$ 161,251	$ 160,742

The following table provides a roll forward of the fair value, as determined by Level 3 inputs, of the ARS during the first six months of 2014:

	Auction Rate Securities (in thousands)
Balance as of December 28, 2013	$ 4,234
Unrealized holding gain on auction rate securities, included in other comprehensive income (loss)	36
Balance as of June 28, 2014	$ 4,270

The following table provides a roll forward of the fair value, as determined by Level 3 inputs, of contingent consideration during the first six months of 2014:

	Contingent Consideration (in thousands)
Balance as of December 28, 2013	$ 43,346
Payments	(6,962)
Change in fair value	(1,436)
Balance as of June 28, 2014	$ 34,948

The following table presents quantitative information about the inputs and valuation methodologies used for our fair value measurements classified in Level 3 of the fair value hierarchy as of June 28, 2014:

	Fair Value at June 28, 2014 (in thousands)	Valuation Methodology	Significant Unobservable Input	Weighted Average (range, if applicable)
Auction rate securities	$ 4,270	Discounted cash flow	Discount rate	1.64%
			Market credit spread	2.34%
			Liquidity factor	0.36%
Levitronix Medical Contingent consideration	$ 17,040	Multiple outcome discounted cash flow	Annual Revenue	$34.5 million to $51.4 million
			Discount rate	0.98%
			Probability of occurrence	10% to 75%
DuraHeart II Contingent consideration	$ 17,908	Multiple outcome discounted cash flow	Milestone dates	2016 to 2030
			Discount rate	5.3% to 17.0%
			Probability of occurrence	5% to 80%

Table of Contents

Auction Rate Securities

The significant unobservable inputs used in the fair value measurement of ARS are the weighted average discount rate, market credit spread and liquidity factor. A significant increase (decrease) in the discount rate in isolation could result in a significantly higher (lower) fair value measurement, whereas a significant increase (decrease) in the market credit spread and liquidity factor in isolation could result in a significantly lower (higher) fair value measurement. Although the discount rate as compared to the market credit spread and liquidity factors are not directly related, they will generally move in opposite directions.

The fair value of ARS is calculated on a quarterly basis by senior management based on a collaborative effort of the corporate treasury and accounting groups. To assess the reasonableness of the fair value measurement, management compares its fair value measurement to the values calculated by independent third parties.

Contingent Consideration

The estimated fair value of the liability for contingent consideration represents revenue and milestone targets related to our Levitronix Medical and DuraHeart II acquisitions, respectively. The fair value of the liability is determined using a discounted cash flow methodology with significant inputs that include projected revenue, discount rate and percentage probability of occurrence for the Levitronix Medical contingent consideration; and regulatory milestone targets, commercial milestones targets, discount rate and percent probability of occurrence of these milestones for the DuraHeart II contingent consideration. A significant increase (decrease) in the projected revenue in isolation could result in a significantly higher (lower) fair value measurement; a significant delay (acceleration) in the projected regulatory milestone achievement date in isolation could result in a significantly lower (higher) fair value measurement; a significant increase (decrease) in the discount rate in isolation could result in a significantly lower (higher) fair value measurement; and the changes in the probability of occurrence between the outcomes in isolation could result in a significant change in fair value measurement.

The fair value of the contingent consideration is calculated on a quarterly basis by management based on a collaborative effort of our regulatory, research and development, operations, finance and accounting groups. Potential valuation adjustments are made as additional information becomes available, including the progress toward achieving revenue and milestone targets as compared to initial projections, the impact of market competition and changes in actual and projected product mix and average selling price, with the impact of such adjustments being recorded in the condensed consolidated statements of operations. During the first six months of 2014, we recorded remeasurement adjustments to decrease the DuraHeart II contingent consideration by $3.2 million (reductions of research and development expense of $1.0 million and selling, general and administrative expense of $2.2 million) as a result of changes to certain underlying assumptions, the probabilities of possible outcomes and accretion expense associated with the passage of time. During the first six months of 2014, we recorded remeasurement adjustments to increase the Levitronx contingent consideration by $1.7 million (reported in selling, general and administrative expense) as a result of changes in the probabilities of possible outcome.

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 evaluated for impairment and adjusted to fair value using Level 3 inputs, only when an impairment is recognized. Fair values are considered Level 3 when management makes significant assumptions in developing a discounted cash flow model based upon a number of considerations including projections of revenues, earnings and a discount rate. In addition, in evaluating the fair value of goodwill impairment, further corroboration is obtained using our market capitalization. No impairment was recorded in either the six months ended June 28, 2014 or June 29, 2013.

Note 4. Foreign Exchange Instruments

We utilize foreign currency forward exchange contracts and options with recognized financial institutions to manage our exposure to the impact of fluctuations in foreign currency exchange rates on certain intercompany balances and foreign currency denominated sales and purchase transactions. We do not use derivative financial instruments for speculative or trading purposes. These forward contracts are not designated as hedging instruments for accounting purposes. Principal hedged currencies include the Euro, British Pound Sterling and U.S. Dollar. The periods of these forward contracts range up to six months and the notional amounts are intended to be consistent with changes in the underlying exposures. We intend to exchange foreign currencies for U.S. Dollars at maturity.

Table of Contents

Total gross notional amounts for outstanding derivatives instruments were as follows:

		June 28, 2014		December 28, 2013
Forward contracts:				
Euro (sell)		22.7 million		20.2 million
British Pound Sterling (sell)	£	1.3 million	£	1.3 million
U.S. Dollar (sell)	$	8.5 million	$	23.5 million
U.S. Dollar (buy)	$	58.5 million	$	60.0 million

The following table shows the derivative instruments measured at gross fair value reported on the condensed consolidated balance sheets:

	As of June 28, 2014				As of December 28, 2013			
	Prepaid expenses and other assets		Other accrued liabilities		Prepaid expenses and other assets		Other accrued liabilities	
	(in thousands)							
Derivatives not designated as hedging instruments (forward contracts)	$	1,134	$	487	$	592	$	156

The following table shows the effect of derivative instruments not designated as hedging instruments and foreign currency transactions gains and losses which were included in Interest income and other in the condensed consolidated statements of operations:

	Three Months Ended				Six Months Ended			
	June 28, 2014		June 29, 2013		June 28, 2014		June 29, 2013	
	(in thousands)							
Foreign currency exchange gain (loss) on foreign contracts	$	(420)	$	(1,477)	$	(67)	$	1,304
Foreign currency transactions gain (loss)		291		1,437		(119)		(1,008)

Note 5. Balance Sheet Information

The following tables provide details of selected condensed consolidated balance sheets items as of the end of each period:

Inventories consisted of the following:

		June 28, 2014		December 28, 2013
	(in thousands)			
Finished goods	$	28,655	$	22,885
Work in process		14,686		13,739

Raw materials	24,026	23,669
Total	$ 67,367	$ 60,293

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

	June 28, 2014	December 28, 2013
	(in thousands)	
Land, building and improvements	$ 20,594	$ 20,594
Equipment and capitalized software	63,256	61,383
Furniture and leasehold improvements	25,048	22,458
Total	108,898	104,435
Less accumulated depreciation	(52,928)	(49,272)
Total	$ 55,970	$ 55,163

As of June 28, 2014, we have $7.6 million of equipment that have not yet been placed in service (included in the Equipment and capitalized software line in the table above) from the DuraHeart II acquisition.

Depreciation expense was $2.3 million and $4.4 million for the three and six months ended June 28, 2014, respectively, and $2.2 million and $4.1 million for the three and six months ended June 29, 2013, respectively.

Table of Contents

Warranty provision, included in Other accrued liabilities on the condensed consolidated balance sheets, and the changes in the balances for the six months ended June 28, 2014 and June 29, 2013 were as follows:

	June 28, 2014		June 29, 2013	
	(in thousands)			
Balance, beginning of the period	$	9,899	$	2,212
Additions		1,710		420
Settlements		(2,258)		(945)
Balance, end of the period	$	9,351	$	1,687

The increased level of warranty activity in the first six months of 2014 as compared to the prior period was due to new warranty additions and settlements related to sales of our HeartMate II Pocket Controller, which was introduced in 2013.

Changes in Accumulated other comprehensive loss by component during the six months ended June 28, 2014:

	Foreign currency items (A)		Unrealized gain (loss) on available-for-sale securities (A)		Total	
			(in thousands)			
Balance as of December 28, 2013	$	(13,039)	$	536	$	(12,503)
Other comprehensive loss before reclassification		678		(1,407)		(729