AtriCure, Inc.
Form 10-Q
November 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

or

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

For the transition period from ______ to ______

Commission File Number 000-51470

AtriCure, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**34-1940305**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

6217 Centre Park Drive

West Chester, OH 45069

(Address of principal executive offices)

(513) 755-4100

(Registrant s telephone number, including area code)

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

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

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

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

Large Accelerated Filer ¨	Accelerated Filer ¨
Non-Accelerated Filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

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

Class	**Outstanding at November 5, 2010**
Common Stock, $.001 par value	15,589,842

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ATRICURE, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 3,526,091	$ 8,905,425
Short-term investments	7,930,184	6,816,673
Accounts receivable, less allowance for doubtful accounts of $3,891 and $24,400, respectively	8,767,264	7,248,087
Inventories, net	6,631,463	4,869,708
Class action settlement recovery receivables	4,750,000	2,000,000
Other current assets	681,989	1,511,335
Total current assets	32,286,991	31,351,228
Property and equipment, net	2,969,540	3,008,699
Intangible assets	106,250	287,653
Other assets	310,669	334,756
Total Assets	$ 35,673,450	$ 34,982,336
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 4,751,692	$ 3,599,943
Accrued liabilities	4,000,566	3,979,176
Accrued class action settlement reserves	4,750,000	2,000,000
Current maturities of long-term debt and capital lease obligations	2,202,105	2,227,431
Total current liabilities	15,704,363	11,806,550
Long-term debt and capital lease obligations	1,171,639	2,669,666
Other liabilities	3,084,829	3,416,360
Total Liabilities	19,960,831	17,892,576
Commitments and contingencies (Note 7)		
Stockholders Equity:		
Common stock, $0.001 par value, 90,000,000 shares authorized and 15,588,016 and 15,353,288 issued and outstanding, respectively	15,588	15,353
Additional paid-in capital	113,335,927	110,900,087
Accumulated other comprehensive income	134,241	144,290
Accumulated deficit	(97,773,137)	(93,969,970)

Total Stockholders Equity	15,712,619	17,089,760
Total Liabilities and Stockholders Equity	$ 35,673,450	$ 34,982,336

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenue	$ 14,473,113	$ 13,281,336	$ 42,617,225	$ 40,733,189
Cost of revenue	3,299,152	3,278,090	9,535,461	9,330,564
Gross profit	11,173,961	10,003,246	33,081,764	31,402,625
Operating expenses:				
Research and development expenses	2,937,043	2,580,766	8,017,414	8,635,938
Selling, general and administrative expenses	9,067,807	8,087,896	28,018,385	25,585,272
Settlement reserve		3,766,623		3,766,623
Goodwill impairment				6,812,389
Total operating expenses	12,004,850	14,435,285	36,035,799	44,800,222
Loss from operations	(830,889)	(4,432,039)	(2,954,035)	(13,397,597)
Other income (expense):				
Interest expense	(199,978)	(241,480)	(677,859)	(580,621)
Interest income	5,222	8,237	18,157	44,073
Other	(2,221)	(35,129)	(189,667)	(216,529)
Loss before income tax (expense) benefit	(1,027,866)	(4,700,411)	(3,803,404)	(14,150,674)
Income tax (expense) benefit	(1,444)	3,441	237	45,714
Net loss	$ (1,029,310)	$ (4,696,970)	$ (3,803,167)	$ (14,104,960)
Basic and diluted net loss per share	$ (0.07)	$ (0.32)	$ (0.25)	$ (0.98)
Weighted average shares outstanding basic and diluted	15,148,815	14,614,217	15,057,672	14,456,954

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW

(Unaudited)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Cash flows from operating activities:		
Net loss	$ (3,803,167)	$ (14,104,960)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Goodwill impairment		6,812,389
Settlement reserve		3,766,623
Share-based compensation expense	2,144,105	2,737,843
Depreciation	1,594,296	1,576,602
Amortization of deferred financing costs	78,648	63,711
Write-off of deferred financing costs		102,485
Amortization of discount on long-term debt	146,738	109,341
Amortization of intangible assets	181,403	211,125
(Gain) loss on disposal of equipment	(1,563)	15,862
Change in allowance for doubtful accounts	(20,509)	(6,954)
Changes in assets and liabilities:		
Accounts receivable	(1,559,264)	84,201
Inventories	(1,786,129)	914,171
Other current assets	762,289	(177,754)
Accounts payable	1,135,987	(1,293,142)
Accrued liabilities	(434,940)	(375,611)
Other non-current assets and non-current liabilities	(4,991)	(105,939)
Net cash (used in) provided by operating activities	(1,567,097)	329,993
Cash flows from investing activities:		
Purchases of property and equipment	(1,534,687)	(1,006,163)
Purchases of available-for-sale securities	(7,263,213)	(5,824,661)
Maturities of available-for-sale securities	6,148,491	
Change in restricted cash and cash equivalents		6,000,000
Net cash used in investing activities	(2,649,409)	(830,824)
Cash flows from financing activities:		
Payments on debt and capital leases	(1,670,091)	(6,928,044)
Proceeds from borrowings of debt		6,500,000
Payment of debt fees	(85,059)	(207,013)
Proceeds from issuance of common stock under employee stock purchase plan	225,084	120,410
Proceeds from stock option exercises	204,354	9,585
Net cash used in financing activities	(1,325,712)	(505,062)
Effect of exchange rate changes on cash and cash equivalents	162,884	131,036
Net decrease in cash and cash equivalents	(5,379,334)	(874,857)
Cash and cash equivalents beginning of period	8,905,425	11,448,451

Cash and cash equivalents end of period	$	3,526,091	$	10,573,594
Supplemental cash flow information:				
Cash paid for interest	$	334,295	$	315,000
Cash paid for income taxes	$	21,639	$	
Non-cash investing and financing activities:				
Purchases of property and equipment in current liabilities	$	46,873	$	2,216
Warrant issued in conjunction with credit facility	$		$	455,000

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of the Business AtriCure, Inc. (the Company or AtriCure) was incorporated in the State of Delaware on October 31, 2000. The Company develops, manufactures and sells devices designed primarily for the surgical ablation of cardiac tissue and devices for the exclusion of the left atrial appendage. The Company sells its products to hospitals and medical centers in the United States and internationally. International sales were $2,918,664 and $2,590,233 during the three months ended September 30, 2010 and 2009, respectively, and $8,167,305 and $7,428,682 during the nine months ended September 30, 2010 and 2009, respectively.

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

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

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

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

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

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

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

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

Product revenue includes shipping and handling revenue of $159,872 and $153,402 for the three months ended September 30, 2010 and 2009, respectively, and $481,089 and $486,293 for the nine months ended September 30, 2010 and 2009, respectively. Cost

ATRICURE, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

of freight for shipments made to customers is included in cost of revenue. Sales and other value-added taxes collected from customers and remitted to governmental authorities are excluded from revenue. The Company sells its products primarily through a direct sales force and through AtriCure Europe, B.V. Terms of sale are generally consistent for both end-users and distributors except that payment terms are generally net 30 days for end-users and net 60 days for distributors.

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

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

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

	September 30, 2010	December 31, 2009
Raw materials	$ 2,853,010	$ 1,839,610
Work in process	659,665	411,738
Finished goods	3,292,478	2,801,530
Reserve for obsolescence	(173,690)	(183,170)
Inventories, net	$ 6,631,463	$ 4,869,708

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

Included in property and equipment are generators and other capital equipment (such as the Company s switchbox units and cryosurgical consoles) that are loaned at no cost to direct customers that use the Company s disposable products. These generators are depreciated over a period of one to three years, which approximates their useful lives, and such depreciation is included in cost of revenue. The estimated useful lives of this equipment are based on anticipated usage by our customers and the timing and impact of expected new technology rollouts by the Company. To the extent the Company experiences changes in the usage of this equipment or introductions of new technologies, the estimated useful lives of this equipment may change in a future period. Depreciation related to these generators was $322,044 and $289,656 for the three months ended September 30, 2010 and 2009, respectively, and $967,557 and $822,913 for the nine months ended September 30, 2010 and 2009, respectively. As of September 30, 2010 and December 31, 2009, the net carrying amount of loaned equipment included in net property and equipment in the Condensed Consolidated Balance Sheets was $1,787,164 and $1,756,638, respectively.

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

Goodwill and Intangible Assets As of December 31, 2008 the Company had $6,812,389 in goodwill, which represented the excess of costs over the fair value of the net assets acquired in business combinations. The Company historically tested its goodwill

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

Net Loss Per Share Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Since the Company has experienced net losses for all periods presented, net loss per share excludes the effect of 3,491,142 and 3,761,073 options, restricted stock and performance based shares as of September 30, 2010 and 2009, respectively, because they are anti-dilutive. Therefore the number of shares calculated for basic net loss per share is also used for the diluted net loss per share calculation.

Comprehensive Loss and Accumulated Other Comprehensive Income (Loss) In addition to net losses, the comprehensive loss includes foreign currency exchange rate adjustments and unrealized gains and losses on investments. The comprehensive loss for the three and nine months ended September 30, 2010 was $788,003 and $3,813,216, respectively. The comprehensive loss for the three and nine months ended September 30, 2009 was $4,600,622 and $13,842,437, respectively.

Accumulated other comprehensive income (loss) consisted of the following:

	Unrealized Gains (Losses) on Short-Term Investments	Foreign Currency Translation Adjustment	Accumulated Other Comprehensive Income (Loss)

Balance as of December 31, 2009	$ 2,685	$ 141,605	$ 144,290
January 1, 2010 to March 31, 2010 change	(1,452)	(89,437)	(90,889)
Balance as of March 31, 2010	1,233	52,168	53,401
April 1, 2010 to June 30, 2010 change	607	(161,074)	(160,467)
Balance as of June 30, 2010	$ 1,840	$ (108,906)	$ (107,066)
July 1, 2010 to September 30, 2010 change	(365)	241,672	241,307
Balance as of September 30, 2010	$ 1,475	$ 132,766	$ 134,241

ATRICURE, INC. AND SUBSIDIARY

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(Unaudited)

Foreign Currency Transaction Gains (Losses) The Company recorded foreign currency transaction gains (losses) of ($10,627) and $4,482 for the three months ended September 30, 2010 and 2009, respectively, and ($170,579) and ($125,774) for the nine months ended September 30, 2010 and 2009, respectively, in connection with partial settlements of its intercompany balance with its subsidiary.

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

Share-Based Compensation The Company follows FASB ASC 718 Compensation-Stock Compensation (ASC 718), to record share-based compensation for all share-based payment awards, including stock options, restricted stock, performance shares and employee stock purchases related to an employee stock purchase plan, based on estimated fair values. The Company s share-based compensation expense recognized under ASC 718 for the three months ended September 30, 2010 and 2009 was $700,919 and $761,107 respectively, and for the nine months ended September 30, 2010 and 2009 was $2,133,739 and $2,725,022, respectively, on a before and after tax basis.

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

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

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

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

The Company has historically issued stock options to non-employee consultants as a form of compensation for services provided to the Company. The Company accounts for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50, Equity-Based Payments to Non-Employees. Because these options do not contain specific performance provisions, there is no measurement date of fair value until the options vest. Therefore, the fair value of the options granted and outstanding prior to their vesting date is remeasured each reporting period. During the three months ended September 30, 2010 and 2009, $4,205 and $5,721, respectively, of compensation expense was recorded as a result of the remeasurement of the fair value of these unvested stock options. During the nine months ended September 30, 2010 and 2009, $10,366 and $12,821, respectively, of expense was recorded as a result of the remeasurement of the fair value of these unvested stock options.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

During the three months ended September 30, 2010 and 2009, $44,125 and $39,610, respectively, of expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options. During the nine months ended September 30, 2010 and 2009, $71,619 and $90,753, respectively, of expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options.

As of September 30, 2010 and December 31, 2009, respectively, fully vested options to acquire 50,254 and 52,359 shares of common stock held by non-employee consultants remained unexercised and a liability of $251,907 and $180,288 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of September 30, 2010 and December 31, 2009, respectively.

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

Use of Estimates The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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

ATRICURE, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. RECENT ACCOUNTING PRONOUNCEMENTS

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

In January 2010, the FASB issued new guidance in ASC 820, Fair Value Measurements and Disclosures, which requires reporting entities to make new disclosures about recurring or nonrecurring fair value measurements including (i) significant transfers into and out of Level 1 and Level 2 fair value measurements and (ii) information on purchases, sales, issuances and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. This new guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for interim and annual periods beginning after December 15, 2010. The Company has incorporated the additional disclosures required for Level 2 fair value measurements. The Company will adopt Level 3 disclosures beginning in the first quarter of 2011.

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

3. FAIR VALUE

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

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

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

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

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ATRICURE, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Total
Assets:				
U.S. government agencies and securities	$ 5,718,241	$	$	$ 5,718,241
Commercial paper		1,798,816		1,798,816
Money market funds		1,174,636		1,174,636
Corporate bonds	713,089			713,089
Total assets	$ 6,431,330	$ 2,973,452	$	$ 9,404,782
Liabilities:				
Derivatives instruments	$	$	$ 251,907	$ 251,907
Total liabilities	$	$	$ 251,907	$ 251,907

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

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

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

	As of September 30, 2010	As of December 31, 2009
Risk free interest rate	0.17% - 1.26%	0.55% - 2.94%
Expected life of option (years)	0.38 - 4.96	1.13 - 5.71
Expected volatility of stock	66.00%	61.00%
Dividend yield	0.00%	0.00%

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

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ATRICURE, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	Fair Value Measurements Using Significant Other Unobservable Inputs (Level 3) Derivative Instruments			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Beginning Balance	$ 207,782	$ 91,512	$ 180,288	$ 40,368
Total losses (realized/unrealized) included in earnings	44,125	39,610	71,619	90,753
Purchases, issuances, and settlement				
Ending Balance	$ 251,907	$ 131,122	$ 251,907	$ 131,122
Losses included in earnings (or changes in net assets attributable to the change in unrealized losses relating to assets held at reporting date)	$ (44,125)	$ (39,610)	$ (71,619)	$ (90,753)

4. GOODWILL AND INTANGIBLE ASSETS

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

	Proprietary manufacturing technology	Non-compete agreement	Trade name	Total
Net carrying amount as of December 31, 2008	$ 344,778	$ 82,292	$ 142,083	$ 569,153
Amortization	(214,000)	(12,500)	(55,000)	(281,500)
Net carrying amount as of December 31, 2009	130,778	69,792	87,083	287,653
Amortization				