AtriCure, Inc.
Form 10-Q
July 30, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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 incorporation or organization)	**(I.R.S. Employer Identification No.)**

6217 Centre Park Drive

West Chester, OH 45069

(Address of principal executive offices)

(513) 755-4100

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: YES 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 x 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 x
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 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 July 23, 2014
Common Stock, $.001 par value	27,471,256

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ATRICURE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)

(Unaudited)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$ 41,978	$ 14,892
Short-term investments	21,223	11,319
Accounts receivable, less allowance for doubtful accounts of $77 and $94, respectively	15,058	13,652
Inventories	12,666	10,214
Other current assets	1,840	2,410
Total current assets	92,765	52,487
Property and equipment, net	6,462	5,643
Long-term investments	11,387	7,914
Intangible assets, net	9,588	10,299
Goodwill	35,386	35,386
Other noncurrent assets	345	218
Total Assets	$ 155,933	$ 111,947
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 7,522	$ 8,605
Accrued liabilities	9,317	16,070
Current maturities of debt and capital leases	41	2,038
Total current liabilities	16,880	26,713
Long-term debt and capital leases	65	4,412
Other noncurrent liabilities	4,768	8,218
Total Liabilities	21,713	39,343
Commitments and contingencies (Note 7)		
Stockholders Equity:		
	27	23

Common stock, $.001 par value, 90,000 shares authorized and 27,471 and 23,248 issued and outstanding, respectively		
Additional paid-in capital	266,985	194,933
Accumulated other comprehensive loss	(178)	(139)
Accumulated deficit	(132,614)	(122,213)
Total Stockholders Equity	134,220	72,604
Total Liabilities and Stockholders Equity	$ 155,933	$ 111,947

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In Thousands, Except Per Share Amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenue	$ 26,514	$ 20,429	$ 51,361	$ 39,859
Cost of revenue	7,733	5,306	14,923	10,650
Gross profit	18,781	15,123	36,438	29,209
Operating expenses:				
Research and development expenses	4,569	3,049	8,570	6,555
Selling, general and administrative expenses	17,065	13,713	38,646	26,093
Total operating expenses	21,634	16,762	47,216	32,648
Loss from operations	(2,853)	(1,639)	(10,778)	(3,439)
Other income (expense):				
Interest expense	(29)	(132)	(266)	(305)
Interest income	23	2	37	6
Other	172	(17)	638	14
Loss before income tax expense	(2,687)	(1,786)	(10,369)	(3,724)
Income tax expense	5	5	32	10
Net loss	$ (2,692)	$ (1,791)	$ (10,401)	$ (3,734)
Basic and diluted net loss per share	$ (0.10)	$ (0.09)	$ (0.40)	$ (0.19)
Weighted average shares outstanding basic and diluted	26,849	20,652	25,813	20,101
Comprehensive loss:				
Unrealized losses on investments	$ (11)	$ (1)	$ (13)	$ (1)
Foreign currency translation adjustment	(28)	12	(26)	(132)
Other comprehensive income (loss)	(39)	11	(39)	(133)
Net loss	(2,692)	(1,791)	(10,401)	(3,734)
Comprehensive loss	$ (2,731)	$ (1,780)	$ (10,440)	$ (3,867)

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

	Six Months Ended June 30,	
	2014	**2013**
Cash flows from operating activities:		
Net loss	$ (10,401)	$ (3,734)
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation expense	3,988	1,338
Depreciation	1,506	951
Loss on disposal of equipment	14	29
Amortization of deferred financing costs	80	46
Amortization of intangible assets	711	6
Amortization/accretion on investments	163	(6)
Change in allowance for doubtful accounts	32	2
Change in fair value of contingent consideration	(2,662)	
Other	95	
Changes in operating assets and liabilities:		
Accounts receivable	(1,448)	(1,463)
Inventories	(2,457)	(320)
Other current assets	572	(240)
Accounts payable	(936)	45
Accrued liabilities	(6,704)	375
Other noncurrent assets and liabilities	(926)	139
Net cash used in operating activities	(18,373)	(2,832)
Cash flows from investing activities:		
Purchases of property and equipment	(2,475)	(1,191)
Purchases of available-for-sale securities	(27,322)	(2,544)
Maturities of available-for-sale securities	5,400	2,900
Sales of available-for-sale securities	8,349	
Net cash used in investing activities	(16,048)	(835)
Cash flows from financing activities:		
Proceeds from sale of stock, net of offering costs of $257 and $212, respectively	65,830	26,872
Payments on debt and capital leases	(6,352)	(1,014)
Payment of debt fees and premium on retirement of debt	(169)	(98)
Proceeds from issuance of common stock under employee stock purchase plan	708	326
Proceeds from stock option exercises	1,637	1,240
Shares repurchased for payment of taxes on stock awards	(153)	(269)

Net cash provided by financing activities	61,501	27,057
Effect of exchange rate changes on cash and cash equivalents	6	(99)
Net increase in cash and cash equivalents	27,086	23,291
Cash and cash equivalents beginning of period	14,892	7,753
Cash and cash equivalents end of period	$ 41,978	$ 31,044
Supplemental cash flow information:		
Cash paid for interest	$ 109	$ 279
Cash paid for taxes	146	30
Non-cash investing and financing activities:		
Accrued purchases of property and equipment	137	63
Assets acquired through capital lease	8	

See accompanying notes to condensed consolidated financial statements.

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ATRICURE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(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 is a leading Atrial Fibrillation (Afib) solutions partner providing innovative products, professional education and support for clinical science to reduce the economic and social burden of Afib. The Company sells its products to hospitals globally through a direct sales force and distributors.

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 accounting principles generally accepted in the United States of America (GAAP) applicable to interim periods. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with 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, 2013 filed with the SEC.

Principles of Consolidation The Condensed Consolidated Financial Statements include the accounts of the Company, AtriCure, LLC, the Company s wholly-owned subsidiary organized in the State of Delaware, Endoscopic Technologies, LLC, the Company s wholly-owned subsidiary organized in the State of Delaware and AtriCure Europe B.V. (AtriCure Europe), 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.

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. Investments with maturities of less than one year are classified as short-term investments. Investments are recorded at fair value, with unrealized gains and losses recorded as accumulated other comprehensive income (loss). The Company recognizes gains and losses when these securities are sold using the specific identification method and includes them in interest income or expense in the Condensed Consolidated Statements of Operations and Comprehensive Loss.

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 determine the timing of revenue recognition based upon factors such as passage of title, payment terms and ability to return

products. The Company recognizes revenue when all of the following criteria are met: (i) there is 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.

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. 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.

Revenue includes shipping and handling revenue of $236 and $197 for the three months ended June 30, 2014 and 2013, respectively, and $463 and $389 for the six months ended June 30, 2014 and 2013, respectively. Cost of freight for shipments made to customers is included in cost of revenue. Sales and other value-added taxes collected from customers and remitted to governmental authorities are excluded from revenue. The Company sells its products primarily through a direct sales force, with certain international markets sold through distributors. 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 adjustments. The Company estimates such provision quarterly based primarily on a specific identification basis, in addition to estimating a general reserve. Increases to the provision result in a reduction of revenue. The provision is included in accrued liabilities in the Condensed Consolidated Balance Sheets.

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ATRICURE, INC. AND SUBSIDIARIES

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(In thousands, except per share amounts)

(Unaudited)

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. The Company s history of write-offs against the allowance has not been significant.

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. 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 excess and obsolete inventory. An inventory reserve based on product usage is estimated and recorded quarterly 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 s history of write-offs against the reserve has not been significant.

Inventories consist of the following:

	June 30, 2014	December 31, 2013
Raw materials	$ 3,939	$ 3,279
Work in process	1,952	1,472
Finished goods	6,775	5,463
Inventories	$ 12,666	$ 10,214

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. The Company reassesses the useful lives of property and equipment annually, and assets are retired if they are no longer in use. 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 $498 and $299 for the three months ended June 30, 2014 and 2013, respectively, and $959 and $569 for the six months ended June 30, 2014 and 2013, respectively. As of June 30, 2014 and December 31, 2013, the net carrying amount of loaned equipment included in net property and equipment in the Condensed Consolidated Balance Sheets was $3,534 and $3,173, respectively.

Impairment of Long-Lived Assets The Company reviews property and equipment for impairment using its best estimates based on reasonable and supportable assumptions and projections.

Intangible Assets Intangible assets with determinable useful lives are amortized on a straight-line basis over the estimated periods benefited. The Company reviews intangible assets for impairment using its best estimates based on reasonable and supportable assumptions and projections.

Goodwill Goodwill represents the excess of purchase price over the fair value of the net assets acquired in business combinations. The Company tests goodwill for impairment annually on November 30, or more often if impairment indicators are present. 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

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(In thousands, except per share amounts)

(Unaudited)

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. As a result, the value of the assets could be significantly reduced, which would increase operating expenses and reduce net income for the period in which the charge occurs.

Other Income Other income consists primarily of foreign currency transaction gains and losses, grant income and non-employee option gains and losses related to the fair market value change for fully vested options outstanding for consultants which are accounted for as free-standing derivatives.

The Company recorded foreign currency transaction gains of $16 and $11 for the three months ended June 30, 2014 and 2013, respectively, and $21 and $56 for the six months ended June 30, 2014 and 2013, respectively, in connection with settlements of its intercompany balance with AtriCure Europe.

The Company periodically is awarded grants to support research and development activities or education activities. The Company recognizes grant income when the funds are earned. The Company recorded grant income of $137 and $0 during the three months ended June 30, 2014 and 2013, respectively. Grant income of $500 and $0 was recorded for the six month periods ended June 30, 2014 and 2013, respectively.

The Company historically issued stock options to non-employee consultants as a form of compensation for services provided to the Company. Because the non-employee 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, Derivatives and Hedging (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 June 30, 2014 and 2013, ($19) and $28, respectively, of (income) expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options. During the six months ended June 30, 2014 and 2013, ($117) and $42, respectively, of (income) expense was recorded as a result of the remeasurement of the fair value of these fully vested stock options.

Taxes Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in the period that includes the enactment date.

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. Deferred tax assets are reduced by valuation allowances if, based on the consideration of all available evidence, it is more-likely-than-not that some portion of the deferred tax asset will not be realized. Significant weight is given to evidence that can be objectively verified. The Company evaluates deferred tax assets on a quarterly basis to determine if valuation allowances are required by considering all available evidence. Deferred tax assets are realized by having sufficient future taxable income to allow the related tax benefits to reduce taxes otherwise payable. The sources of taxable income that may be available to realize the benefit of deferred tax assets are future reversals of existing taxable temporary differences, future taxable income, exclusive of reversing temporary differences and carryforwards, taxable income in carry-back years and tax planning strategies that are both prudent and feasible. In evaluating whether to record a valuation allowance, the applicable accounting standards deem that the existence of cumulative losses in recent years is a significant piece of objectively verifiable negative evidence that must be overcome by objectively verifiable positive evidence to avoid the need to record a valuation allowance. The Company has recorded a full valuation allowance against its net deferred tax assets as it is more likely than not that the benefit of the deferred tax assets will not be recognized in future periods.

A provision of The Patient Protection and Affordable Care Act enacted in 2010, as amended (the Affordable Care Act), requires manufacturers of medical devices to pay an excise tax on all U.S. medical device sales beginning in January 2013. The Company s expense related to the medical device excise tax, which was recorded in cost of revenue, was $116 and $128 for the three months ended June 30, 2014 and 2013, respectively, and $230 and $248 for the six months ended June 30, 2014 and 2013, respectively.

Net Loss Per Share Basic and diluted net loss per share is computed in accordance with FASB ASC 260, Earnings Per Share (ASC 260) 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 3,799 and 2,588 options and restricted stock shares as of June 30, 2014 and 2013, 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.

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Comprehensive Loss and Accumulated Other Comprehensive Income (Loss) In addition to net losses, the comprehensive loss includes foreign currency translation adjustments and unrealized gains and losses on investments.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Total accumulated other comprehensive (loss) income at beginning of period	$ (139)	$ (67)	$ (139)	$ 77
Unrealized Gains on Investments				
Balance at beginning of period	$ (8)	$ 1	$ (6)	$ 1
Other comprehensive income before reclassifications	(11)	(1)	(13)	(1)
Amounts reclassified from accumulated other comprehensive income to other income on the statement of operations				
Balance at end of period	$ (19)	$	$ (19)	$
Foreign Currency Translation Adjustment				
Balance at beginning of period	$ (131)	$ (68)	$ (133)	$ 76
Other comprehensive income before reclassifications	(44)	1	(47)	(188)
Amounts reclassified from accumulated other comprehensive income to other income on the statement of operations	16	11	21	56
Balance at end of period	$ (159)	$ (56)	$ (159)	$ (56)
Total accumulated other comprehensive loss at end of period	$ (178)	$ (56)	$ (178)	$ (56)

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 employee share-based payment awards, including stock options, restricted stock, performance shares and stock purchases related to an employee stock purchase plan, based on estimated fair values. The Company s share-based compensation expense recognized under ASC 718 for the three months ended June 30, 2014 and 2013 was $1,846 and $820, respectively, and $3,988 and $1,338 for the six months ended June 30, 2014 and 2013, 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 and Comprehensive Loss. 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 time-based 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 expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors. The fair value of market-based performance option grants is estimated at the date of grant using a Monte-Carlo simulation. 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 Condensed Consolidated Statements of Operations and Comprehensive Loss. The expense has been reduced for estimated forfeitures.

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ATRICURE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

The Company estimates the fair value of restricted stock 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. Estimated forfeitures reduce the amount of expense recorded for restricted stock.

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. Because the stock options require settlement by the Company s delivery of registered shares and because the tax withholding provisions in the award agreements allow the stock options to be partially net-cash settled, these vested stock options are no longer eligible for equity classification and are, thus, accounted for as derivative liabilities under FASB ASC 815 until the stock options are ultimately either exercised or forfeited. Accordingly, the vested non-employee consultant stock options are classified as liabilities and remeasured at fair value through earnings at each reporting period. Fully vested options to acquire 33 and 38 shares of common stock held by non-employee consultants remained unexercised as of June 30, 2014 and December 31, 2013, respectively. A liability of $186 and $350 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013, respectively.

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 expense during the reporting period. Actual results could differ from those estimates.

Fair Value Disclosures The book 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 and other liabilities, approximate their fair values. The Company classifies cash and short-term investments in U.S. government agencies and securities as Level 1 within the fair value hierarchy. Accounts receivable, short-term other assets, accounts payable and accrued expenses are also classified as Level 1. The carrying amounts of these assets and liabilities approximate their fair value due to their relatively short-term nature. Other assets and other liabilities are classified as Level 1 within the fair value hierarchy. Cash equivalents and short-term investments in commercial paper are classified as Level 2 within the fair value hierarchy (see Note 3 Fair Value for further information). Significant unobservable inputs with respect to the fair value measurement of the Level 3 non-employee stock options are developed using Company data. When an input is changed, the Black-Scholes model is updated and the results are analyzed for reasonableness. Significant unobservable inputs with respect to the fair value measurement of the Level 3 acquisition-related contingent consideration are developed using Company data. When an input is changed, the

expected present value calculation is updated and the results are analyzed for reasonableness.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2013 the FASB issued FASB ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists . This new guidance eliminates the diversity in practice for the financial statement presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss or a tax credit carryforward is available to reduce the taxable income or tax payable that would result from disallowance of a tax position. This ASU is effective for interim and annual reporting periods beginning after December 15, 2013. The Company has evaluated the provisions of ASU 2013-11 and has determined that they do not have a material impact on the Company s financial reporting.

In September 2013 the United States Treasury Department and the IRS issued final and proposed regulations (the Tangible Property Regulations) effective for tax years beginning on or after January 1, 2014, that provided guidance on a number of matters with regard to tangible property, including whether expenditures qualified as deductible repairs, the treatment of materials and supplies, capitalization of tangible property, dispositions of property and related elections. The Company has evaluated the regulations and has determined that they do not have a material impact on the Company s financial reporting.

In May 2014 the FASB issued a final standard on revenue from contracts with customers. The standard, issued as FASB ASU 2014-09, Revenue from Contracts with Customers (ASU 2014-09), outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance. The ASU is effective for interim and annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. A full

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ATRICURE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

retrospective or modified retrospective approach may be taken to adopt the guidance in the ASU. The Company is currently evaluating the impact of the provisions of ASU 2014-09 on its consolidated financial position, results of operations and related disclosures.

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. The fair value of the Company s Level 3 contingent consideration was estimated on the acquisition date of Endoscopic Technologies, Inc. (Estech) and is revalued at the end of each reporting period.

In accordance with ASC 820, the following table represents the Company s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2014:

	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	$	$ 38,365	$	$ 38,365
Commercial paper		2,795		2,795
U.S. government agencies and securities	5,159			5,159
Corporate bonds		24,656		24,656
Total assets	$ 5,159	$ 65,816	$	$ 70,975
Liabilities:				
Derivative instruments	$	$	$ 186	$ 186
Acquisition-related contingent consideration			5,370	5,370
Total liabilities	$	$	$ 5,556	$ 5,556

There were no changes in the levels or methodology of measurement of financial assets and liabilities during the six-month period ended June 30, 2014.

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In accordance with ASC 820, the following table represents the Company s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2013:

	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	$	$ 4,295	$	$ 4,295
Commercial paper		2,598		2,598
U.S. government agencies and securities	4,145			4,145
Corporate bonds		12,490		12,490
Total assets	$ 4,145	$ 19,383	$	$ 23,528
Liabilities:				
Derivative instruments	$	$	$ 350	$ 350
Acquisition-related contingent consideration			8,032	8,032
Total liabilities	$	$	$ 8,382	$ 8,382

There were no changes in the levels of financial assets and liabilities during the twelve months ended December 31, 2013.

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

	As of June 30, 2014	As of December 31, 2013
Risk free interest rate	0.18% 1.11%	0.11% 1.32%
Expected life of option (years)	1.21 3.61	0.75 4.10

Expected volatility of stock	19.00%	37.00%	70.00%
Dividend yield	0.00%		0.00%

The Company 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 award agreements 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 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 and dividend yield. Due to the lack of certain observable market quotes, the Company utilizes valuation models that rely on some Level 3 inputs. The Company s estimate of volatility is based on the Company s trading history. In accordance with ASC 820, the following table represents the Company s Level 3 fair value measurements using significant other unobservable inputs for derivative instruments as of June 30, 2014:

Beginning Balance January 1, 2014	$ 350
Total gains/losses (realized/unrealized) included in earnings	(124)
Purchases (exercises)	(40)
Reclassification from equity to liability when fully vested	
Ending Balance June 30, 2014	$ 186
Losses included in earnings (or changes in net assets attributable to the change in unrealized gains relating to assets held at reporting date)	$ 124

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In accordance with ASC 820, the following table represents the Company s Level 3 fair value measurements using significant other unobservable inputs for derivative instruments as of December 31, 2013:

Beginning Balance January 1, 2013	$ 78
Total gains/losses (realized/unrealized) included in earnings	272
Purchases (exercises)	
Reclassification from equity to liability when fully vested	
Ending Balance December 31, 2013	$ 350
Gains included in earnings (or changes in net assets attributable to the change in unrealized losses relating to assets held at reporting date)	$ (272)

Acquisition-Related Contingent Consideration. The Company acquired Estech on December 31, 2013. The aggregate consideration paid to Estech shareholders includes up to $26,000 of contingent consideration to be paid based on the achievement of certain performance-based milestones in 2014 and 2015. The fair value of the contingent consideration was estimated using an expected present value approach to estimate an expected value, which, in statistical terms, is the weighted average of a discrete random variable s possible values with the respective probabilities as the weights. This fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement within the fair value hierarchy. Using this valuation technique, the fair value of the contingent consideration was determined to be $5,370 and $8,032 as of June 30, 2014 and December 31, 2013, respectively.

The estimated fair values of assets acquired and liabilities assumed in the acquisition of Estech are provisional and are based on the information that was available as of the acquisition date to estimate the fair value of assets acquired and liabilities assumed. The Company believes that information provides a reasonable basis for estimating the fair values but the Company is waiting for additional information necessary to finalize those amounts, particularly with respect to the estimated fair value of intangible assets, deferred revenue, deferred taxes and goodwill. The potential for measurement period adjustments related to the acquired assets and assumed liabilities exists based on AtriCure s continuing review of all matters related to the acquisition. Such changes could be significant. The Company expects to finalize the valuation and complete the purchase price allocation as soon as practicable but no later than one year from the acquisition date.

The following table represents the Company s Level 3 fair value measurements using significant other unobservable inputs for acquisition-related contingent consideration as of June 30, 2014:

Beginning Balance January 1, 2014	$ 8,032
Amounts acquired (sold) or issued (settled), net	
Transfers in and/or (out) of Level 3	
Changes in fair value recorded in earnings	(2,662)
Ending Balance June 30, 2014	$ 5,370

The following table represents the Company s Level 3 fair value measurements using significant other unobservable inputs for acquisition-related contingent consideration as of December 31, 2013:

Beginning Balance January 1, 2013	$
Amounts acquired (sold) or issued (settled), net	8,032
Transfers in and/or (out) of Level 3	
Changes in fair value recorded in earnings	
Ending Balance December 31, 2013	$ 8,032

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4. 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:

	Non-Compete Agreement	Fusion Technology	Clamp & Probe Technology	Estech Trade Name	Total
Net carrying amount as of December 31, 2012	$ 32	$	$	$	$ 32
Amortization	(12)				(12)
Additions		9,242	829	208	10,279
Net carrying amount as of December 31, 2013	$ 20	$ 9,242	$ 829	$ 208	$ 10,299
Amortization	(7)	(462)	(138)	(104)	(711)
Net carrying amount as of June 30, 2014	$ 13	$ 8,780	$ 691	$ 104	$ 9,588

The Company s amortization term for a non-compete agreement is eight years. Fusion technology is being amortized over ten years, clamp and probe technology is being amortized over three years and the Estech trade name is being amortized over one year.

Amortization expense related to intangible assets with definite lives was $356 and $3 for the three months ended June 30, 2014 and 2013, respectively, and $711 and $6 for the six months ended June 30, 2014 and 2013, respectively.

Future amortization expense related to intangible assets with definite lives is projected as follows:

2014	$ 710	July 1, 2014 through December 31, 2014
2015	1,208	
2016	1,201	
2017	924	
2018	924	

2019 and thereafter	4,621
Total	$ 9,588

5. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

	June 30, 2014	December 31, 2013
Accrued commissions	$ 2,867	$ 3,827
Accrued bonus	2,141	6,849
Accrued contingent consideration	770	
Accrued vacation	539	476
Accrued taxes and value-added taxes payable	469	907
Withheld payroll taxes	414	546
Other accrued liabilities	388	1,105
Accrued settlement reserve	372	1,259
Accrued employee medical	294	
Accrued royalties	263	307
Accrued payroll	207	233
Accrued non-employee stock options	186	350
Accrued retention and severance	172	22
Sales/returns allowance - trade	139	105
Accrued 401(k) match	96	84
Total	$ 9,317	$ 16,070

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6. INDEBTEDNESS

The Company has had a debt agreement with Silicon Valley Bank (SVB) since May 1, 2009. The agreement, as amended, restated and modified, includes a $15,000 revolving credit facility which matures on April 30, 2016. A $10,000 term loan was part of the Company s debt agreement with SVB until it was repaid in full in March 2014. The Company recorded $37 of accelerated amortization expense related to deferred financing costs on the term loan in March 2014.

Effective April 30, 2014 the Company and SVB entered into a Joinder and Seventh Loan Modification Agreement which set forth certain amendments to the Company s revolving credit facility with the bank. Key changes in this Modification Agreement included: (i) extending the expiration to April 30, 2016, (ii) increasing the revolving credit facility to $15,000, (iii) reducing the unused revolving line facility fee, (iv) removing the US Export-Import Bank portion of the facility, and (v) adding the Company s wholly-owned subsidiary, Endoscopic Technologies, LLC, as a borrower.

The debt agreement, as amended restated and modified, contains covenants that include, among others, covenants that limit the Company s and its subsidiaries ability to dispose of assets, enter into mergers or acquisitions, incur indebtedness, incur liens, pay dividends or make distributions on the Company s capital stock, make investments or loans, and enter into certain affiliate transactions, in each case subject to customary exceptions for a credit facility of this size and type. Additional covenants apply when the Company has outstanding borrowings under the revolving credit facility or when the Company achieves specific covenant milestones. Financial covenants under the credit facility, as amended, include a minimum EBITDA, and a minimum liquidity ratio. Further, a minimum fixed charge ratio applies when the Company achieves specific covenant milestones. None of the specific covenant milestones have been met as of June 30, 2014. The occurrence of an event of default could result in an increase to the applicable interest rate by 3.0%, an acceleration of all obligations under the Agreement, an obligation of the Company to repay all obligations in full and a right by SVB to exercise all remedies available to it under the Agreement and related agreements including the Guaranty and Security Agreement.

As of June 30, 2014 the Company had no borrowings under the revolving credit facility and had borrowing availability of $10,000. As of December 31, 2013 the Company had no borrowings under its revolving credit facility and borrowing availability of $8,299. As of June 30, 2014 and December 31, 2013, $0 and $6,333, respectively, was outstanding under the term loan, which included $2,000 classified as current maturities of long-term debt as of December 31, 2013. As of June 30, 2014 and December 31, 2013 the Company had an outstanding letter of credit of 75 issued to its European subsidiary s corporate credit card program provider which will expire on June 30, 2015. In addition, if the guarantee by the Export-Import Bank of the United States ceases to be in full force and effect, the Company must repay all loans under the Export-Import agreement.

As of June 30, 2014 the Company had capital leases for computer and office equipment that expire at various terms through 2018. The cost of the assets under lease was $161. These assets are depreciated over their estimated useful lives, which equal the terms of the leases. Accumulated amortization on the capital leases was $61 at June 30, 2014.

Maturities on capital lease obligations are as follows:

2014	$ 20	July 1, 2014 through December 31, 2014
2015	40	
2016	32	
2017	13	
2018	1	
Total	$ 106	

7. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases various types of office, manufacturing and warehouse facilities and equipment under noncancelable operating leases that expire at various terms through 2021.

Royalty Agreements

The Company has certain royalty agreements in place with terms that include payment of royalties based on product revenue from sales of current products. The royalty agreements have effective dates as early as 2003 and terms ranging from three years to at least twenty years. The royalties range from 1.5% to 5% of product sales. One of the agreements includes minimum quarterly

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payments of $50 through 2015 and a maximum of $2,000 in total royalties over the term of the agreement. Parties to the royalty agreements have the right at any time to terminate the agreement immediately for cause. Royalty expense of $262 and $217 was recorded as part of cost of revenue for the three months ended June 30, 2014 and 2013, respectively, and $569 and $539 for the six months ended June 30, 2014 and 2013.

Purchase Agreements

The Company has had a purchase agreement with MicroPace Pty Ltd Inc. (MicroPace) since June 2007. The agreement, as amended, provides for MicroPace to produce a derivative of one of their products tailored for the cardiac surgical environment, known as the MicroPace ORLab (ORLab) for worldwide distribution by the Company. Pursuant to the terms of the amended agreement, in order for the Company to retain exclusive distribution rights of the ORLab, the Company is required to purchase a minimum number of units during a specific time period to extend exclusivity through the following year. Units purchased in excess of yearly minimums reduce future minimum purchase requirements. The current terms of the amended agreement require the Company to purchase a minimum of 40 units between December 1, 2013 and December 31, 2014 to extend the exclusivity period to January 1, 2015 to December 31, 2016. The Company has purchased 99 units since December 1, 2013.

Legal

The Company is not party to any material pending or threatened litigation, except as described below:

Department of Justice Investigation

In October 2008 the Company received a letter from the Department of Justice (DOJ) informing the Company that it was conducting an investigation for potential False Claims Act (FCA) and common law violations relating to its surgical ablation devices. Specifically, the letter stated that the DOJ was investigating the Company s marketing practices utilized in connection with its surgical ablation system to treat Afib, a specific use outside the FDA s 510(k) clearance. The letter also stated that the DOJ was investigating whether the Company instructed hospitals to bill Medicare for cardiac surgical ablation using incorrect billing codes. The Company cooperated with the investigation and operated its business in the ordinary course during the investigation. In December 2009 the Company reached a tentative settlement with the DOJ to resolve the investigation and recorded a liability and charged operating expenses for a total of $3,956, which represented the net present value of the proposed settlement amount to be paid to the DOJ, the Relator, and Relator s counsel (total payments based on the settlement inclusive of interest were estimated to be $4,350, payable over five years).

The settlement was finalized pursuant to the preliminary terms in February 2010, and the Company entered into a settlement agreement with the DOJ, the Office of the Inspector General (OIG), and the Relator in the *qui tam* complaint discussed below. The settlement agreement definitively resolved all claims related to the DOJ investigation.

The Company did not admit nor will it admit to any wrongdoing in connection with the settlement. As of June 30, 2014 the Company had made $3,975 in payments (including interest), and had a liability related to this settlement totaling $372, all of which was classified as current.

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

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

8. INCOME TAX PROVISION

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

The Company s provision for income taxes for continuing operations in interim periods is computed by applying its estimated annual effective rate against its loss before income tax (expense) benefit for the period. In addition, non-recurring or discrete items are recorded during the period in which they occur. The effective tax rate for the three months ended June 30, 2014 and 2013 was (0.19%) and (0.28%), respectively. The effective tax rate for the six months ended June 30, 2014 and 2013 was (0.31%) and (0.27%), respectively.

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

9. EQUITY COMPENSATION PLANS

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

2001 Plan and 2005 Plan

The 2001 Plan is no longer used for granting incentives. Under the 2005 Plan, the Board of Directors may grant incentive stock options to employees and any parent or subsidiary s employees, and may grant nonstatutory stock options, restricted stock, stock appreciation rights, performance units or performance shares to employees, directors and consultants of the Company and any parent or subsidiary s employees, directors and consultants. The administrator (currently the Compensation Committee of the Board of Directors) has the power to determine the terms of any awards, including the exercise price of options, the number of shares subject to each award, the exercisability of the awards and the form of consideration.

Options granted under the plans generally expire ten years from the date of grant. Options granted from the 2005 Plan generally vest at a rate of 25% on the first anniversary date of the grant and ratably each month thereafter over the following three years. Restricted stock awards granted under the 2005 Plan vest 25% annually over four years from date of grant.

As of June 30, 2014 7,649 shares of common stock had been reserved for issuance under the 2005 Plan. The shares authorized for issuance under the 2005 Plan include: (a) shares reserved but unissued under the 2001 Plan as of August 10, 2005, (b) shares returned to the 2001 Plan as the result of termination of options or the repurchase of shares issued under such plan, and (c) annual increases in the number of shares available for issuance on the first day of each year equal to the lesser of:

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

825 shares; or

an amount the Company s Board of Directors may determine.

On January 1, 2014 an additional 756 shares were authorized for issuance under the 2005 Plan representing 3.25% of the outstanding shares on that date. As of June 30, 2014 there were 986 shares available for future grants under the plans.

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Activity under the Plans during the three months ended June 30, 2014 was as follows:

Time-Based Stock Options	Number of Shares Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	2,423	$ 8.61		
Granted	582	19.63		
Exercised	(185)	8.84		
Cancelled or forfeited	(32)	9.53		
Outstanding at June 30, 2014	2,788	$ 10.88	7.0	$ 21,879
Vested and expected to vest	2,647	$ 10.74	6.9	$ 21,084
Exercisable at June 30, 2014	1,394	$ 9.00	5.0	$ 13,066

Restricted Stock	Number of Shares Outstanding	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2014	248	$ 7.75
Granted	341	20.62
Released	(27)	9.01
Forfeited	(1)	9.15
Outstanding at June 30, 2014	561	$ 15.51

The total intrinsic value of options exercised during the three month periods ended June 30, 2014 and 2013 was $212 and $135, respectively. The total intrinsic value of options exercised during the six month periods ended June 30, 2014 and 2013 was $2,063 and $599, respectively. As a result of the Company s tax position, no tax benefit was recognized related to the stock option exercises. For the six month periods ended June 30, 2014 and 2013,

respectively, $1,637 and $1,240 in cash proceeds was included in the Company s Condensed Consolidated Statements of Cash Flows as a result of the exercise of stock options. The total fair value of restricted stock vested during the three month periods ended June 30, 2014 and 2013 was $246 and $98, respectively. The total fair value of restricted stock vested during the six month periods ended June 30, 2014 and 2013 was $507 and $705, respectively. The exercise price per share of each option is equal to the fair market value of the underlying share on the date of grant. The Company issues registered shares of common stock to satisfy stock option exercises and restricted stock grants.

The Company recognized expense related to time-based stock options and restricted stock for the three months ended June 30, 2014 and 2013 of $1,514 and $747, respectively. The Company recognized expense related to time-based stock options and restricted stock for the six months ended June 30, 2014 and 2013 of $2,246 and $1,206, respectively. As of June 30, 2014 there was $17,969 of unrecognized compensation costs related to unvested time-based stock option and restricted stock arrangements ($10,403 relating to stock options and $7,566 relating to restricted stock). This cost is expected to be recognized over a weighted average period of 2.9 years for stock options and 3.1 years for restricted stock.

The Company awarded 225 performance options to its new President and Chief Executive Officer (CEO) when he joined the Company in November 2012, and an additional 225 performance options were awarded to the CEO in January 2014. The options expire ten years from the date of grant and vest in increments of 25 shares when the volume adjusted weighted average closing price of the common stock of the Company as reported by NASDAQ (or any other exchange on which the common stock of the Company is listed) for 30 consecutive days equals or exceeds each of $10.00 per share, $12.50 per share, $15.00 per share, $17.50 per share, $20.00 per share, $25.00 per share, $30.00 per share, $35.00 per share and $40.00 per share. In accordance with FASB ASC 718, a Monte Carlo simulation was performed for both grants to estimate the fair values, vesting terms and vesting probabilities for each tranche of options. Expense calculated using these estimates is being recorded over the estimated vesting terms. The Company recognized expense related to the performance options during the three months ended June 30, 2014 and 2013 of $154 and $45, respectively. The Company recognized expense related to the performance options during the six months ended June 30, 2014 and 2013 of $1,456 and $83, respectively. All expense related to the vested performance options has been recorded as of June 30, 2014. There was $1,170 of unrecognized compensation cost related to unvested performance options as of June 30, 2014. This cost is expected to be recognized over a weighted-average period of 1.2 to 3.6 years. The $10.00, $12.50, $15.00, $17.50 and $20.00 market conditions were met as of June 30, 2014; therefore, 250 of the performance options were exercisable.

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Employee Stock Purchase Plan (ESPP)

During 2008 the Company established its 2008 Employee Stock Purchase Plan (ESPP) which is available to eligible employees as defined in the ESPP. Under the ESPP, shares of the Company s common stock may be purchased at a discount (currently 15%) of the lesser of the closing price of the Company s common stock on the first trading day or the last trading day of the offering period. The offering period (currently six months) and the offering price are subject to change. Participants may not purchase more than $25 of the Company s common stock in a calendar year and, effective January 1, 2014, may not purchase more than 2.5 shares during an offering period. Beginning on January 1, 2009 and on the first day of each fiscal year thereafter during the term of the ESPP, the number of shares available for sale under the ESPP shall be increased by the lesser of (i) two percent (2%) of the Company s outstanding shares of common stock as of the close of business on the last business day of the prior calendar year, not to exceed 600 shares, or (ii) a lesser amount determined by the Board of Directors. At June 30, 2014 there were 617 shares available for future issuance under the ESPP. Share-based compensation expense with respect to the ESPP was $178 and $73 for the three months ended June 30, 2014 and 2013, respectively. Share-based compensation expense with respect to the ESPP was $286 and $132 for the six months ended June 30, 2014 and 2013, respectively.

Valuation and Expense Information Under FASB ASC 718

The following table summarizes share-based compensation expense related to employee share-based compensation under FASB ASC 718 for the three and six months ended June 30, 2014 and 2013. This expense was allocated as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Cost of revenue	$ 93	$ 69	$ 164	$ 127
Research and development expenses	267	59	399	100
Selling, general and administrative expenses	1,486	692	3,425	1,111
Total share-based compensation expense related to employees	$ 1,846	$ 820	$ 3,988	$ 1,338

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014		2013		2014		2013	
Risk free interest rate	1.61%	2.03%	0.75%	1.38%	1.56%	2.12%	0.75%	1.51%
Expected life of option (years)	5.31	6.72	5.33	6.91	5.31	6.72	5.31	7.38
Expected volatility of stock	65.00%	70.00%	69.00%		65.00%	70.00%	69.00%	
Weighted-average volatility	69.00%		69.00%		70.00%		69.00%	
Dividend yield	0.00%		0.00%		0.00%		0.00%	

The Company s estimate of volatility is based solely on the Company s trading history. The risk-free interest rate assumption is based upon the U.S. treasury yield curve at the time of grant for the expected option life. The Company estimates the expected terms of options using historical employee exercise behavior adjusted for abnormal activity.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Stock options	$ 10.33	$ 5.52	$ 12.48	$ 5.50
Restricted stock		8.92	20.62	8.92

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In calculating compensation expense for performance options, the fair value of the options was estimated on the grant date using a Monte Carlo simulation including the following assumptions:

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014		2013	2014		2013
Strike price	$5.91	$21.04	$5.91	$5.91	$21.04	$5.91
Contractual term (years)	10.00		10.00	10.00		10.00
Expected volatility of stock	60.50%	69.60%	69.60%	60.50%	69.60%	69.60%
Expected rate of return	1.75%	2.73%	1.75%	1.75%	2.73%	1.75%
Dividend yield	0.00%		0.00%	0.00%		0.00%

The contractual term assumes that the performance options issued to a high ranking executive of the Company upon hire will be held until expiration. Expected volatility is estimated based on the Company s trading history. The expected rate of return assumption is based upon the U.S. treasury yield curve at the time of grant for the expected option life.

Based on the assumptions noted above, the estimated grant date fair value per share of the performance options granted were as follows:

	Price Target	Fair Value of 2012 Grant	Fair Value of 2014 Grant
Tranche 1	$ 10.00	$ 4.32	$ 14.74
Tranche 2	12.50	4.30	14.74
Tranche 3	15.00	4.27	14.74
Tranche 4	17.50	4.23	14.74
Tranche 5	20.00	4.19	14.73
Tranche 6	25.00	4.10	14.73
Tranche 7	30.00	4.01	14.71
Tranche 8	35.00	3.92	14.67
Tranche 9	40.00	3.83	14.61

Non-Employee Stock Compensation

The Company historically issued nonstatutory common stock options to consultants to purchase shares of common stock as a form of compensation for services provided to the Company. Such options vest over a service period ranging from immediately to four years. After January 1, 2006 all stock options granted to non-employee consultants have a four year vesting period and vest at a rate of 25% on the first anniversary date of the grant and ratably each month thereafter.

The Company accounted for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50. Because these options did not contain specific performance provisions, there was no measurement date of fair value until the options vested. Therefore, the fair value of the options granted and outstanding prior to their vesting date was remeasured each reporting period. The fair value was determined using the Black-Scholes model. No non-employee stock options have been granted since 2008. The values attributable to the unvested portion of the non-employee stock options were amortized over the service period on a graded vesting method, and the vested portion of these stock options was remeasured at each vesting date. As of June 30, 2014 all non-employee consultant options were fully vested.

Once these non-employee consultant stock options have vested, the awards no longer fall within the scope of ASC 505-50. Because the stock options require settlement by the Company s delivery of registered shares and because the tax withholding provisions in the award agreements allow the stock options to be partially net-cash settled, these vested stock options are no longer eligible for equity classification and are, thus, accounted for as derivative liabilities under FASB ASC 815 until the stock options are ultimately either exercised or forfeited. Accordingly, the vested non-employee consultant stock options are classified as liabilities and remeasured at fair value through earnings at each reporting period. During the three months ended June 30, 2014 and 2013, ($19) and $28, respectively, of (income) expense was recorded as a result of the remeasurement of the fair value of these stock options. During the six months ended June 30, 2014 and 2013, ($117) and $42, respectively, of (income) expense was recorded as a result of the remeasurement of the fair value of these stock options. As of June 30, 2014 and December 31, 2013, fully vested stock options to acquire 33 and 38 shares of common stock held by non-employee consultants remained unexercised and a liability of $186 and $350 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013, respectively.

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ATRICURE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

10. SEGMENT AND GEOGRAPHIC INFORMATION

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

Revenue by geographic area was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
United States	$ 19,903	$ 15,454	$ 38,046	$ 30,093
Europe	4,303	2,797	8,607	5,417
Asia	2,175	1,957	4,471	4,018
Other international	133	221	237	331
Total international	6,611	4,975	13,315	9,766
Total revenue	26,514	20,429	51,361	39,859

Domestic revenue by product type was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Open-heart ablation	$ 10,856	$ 9,154	$ 21,233	$ 18,275
Minimally invasive ablation	4,393	3,511	7,841	6,643
AtriClip	3,951	2,789	7,571	5,175
Total ablation and AtriClip	19,200	15,454	36,645	30,093
Valve tools	703		1,401	
Total domestic	19,903	15,454	38,046	30,093

International revenue by product type was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Open-heart ablation	$ 4,054	$ 3,379	$ 8,025	$ 6,637
Minimally invasive ablation	1,966	1,253	3,969	2,587
AtriClip	404	343	847	542
Total ablation and AtriClip	6,424	4,975	12,841	9,766
Valve tools	187		474	
Total international	6,611	4,975	13,315	9,766

The majority of the Company s long-lived assets are located in the United States.

11. PUBLIC OFFERING OF COMMON STOCK

In January 2013 the Company completed a public offering of common stock under its July 2011 shelf registration. The Company sold 3,996 shares of common stock, par value $0.001 per share, at a price of $7.25 per share, generating proceeds of $26,872 after expenses. Offering costs were recorded in additional paid in capital to offset proceeds.

In February 2014 the Company completed a public offering of common stock under its January 2014 shelf registration. The Company sold 3,661 shares of common stock, par value $0.001 per share, at a price of $19.25 per share, generating proceeds of $65,830 after expenses. Offering costs were recorded in additional paid in capital to offset proceeds.

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

(Dollar amounts referenced in this Item 2 are in thousands, except per share amounts.)

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto contained in Item 1 of Part I of this Form 10-Q and our audited financial statements and notes thereto as of and for the year ended December 31, 2013 included in our Form 10-K filed with the Securities and Exchange Commission (SEC) to provide an understanding of our results of operations, financial condition and cash flows.

Forward-Looking Statements

This Form 10-Q, including the sections titled Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors, contains forward-looking statements regarding our future performance. All forward-looking information is inherently uncertain and actual results may differ materially from assumptions, estimates or expectations reflected or contained in the forward-looking statements as a result of various factors, including those set forth under Risk Factors and elsewhere in this quarterly report on Form 10-Q, and in our annual report on Form 10-K for the year ended December 31, 2013. Forward-looking statements convey our current expectations or forecasts of future events. All statements contained in this Form 10-Q other than statements of historical fact are forward-looking statements. Forward-looking statements include statements regarding our future financial position, business strategy, budgets, projected costs, plans and objectives of management for future operations. The words may, continue, estimate, intend, plan, will, believe, project, expect, anticipa expressions may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking. With respect to the forward-looking statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements speak only as of the date of this Form 10-Q. We undertake no obligation to publicly update or revise any forward-looking statements to reflect new information or future events or otherwise unless required by law.

Overview

We are a leading atrial fibrillation (Afib) solutions partner providing innovative products, professional education and support for clinical science to reduce the economic and social burden of Afib. Our Isolator Synergy® Ablation System (Isolator Synergy System) is the first and only device approved by the United States Food and Drug Administration (FDA) for the surgical treatment of persistent and long-standing persistent forms of Afib in patients undergoing certain open concomitant procedures. We have two primary product lines for the ablation of cardiac tissue. Our primary product line for the ablation of cardiac tissue is our Synergy System, a bipolar radiofrequency (RF) ablation device. We also offer a cryoablation product line, which features reusable and disposable cryoablation devices. Additionally, we offer the AtriClip® Gillinov-Cosgrove Left Atrial Appendage (LAA) Occlusion System (AtriClip system), which is designed to exclude the left atrial appendage and is the most widely implanted device for LAA management worldwide.

Cardiothoracic surgeons have adopted our RF ablation and cryoablation systems to treat Afib in an estimated 158,000 patients since 2004, and we believe that we are currently the market leader in the surgical treatment of Afib. Our products are utilized by cardiothoracic surgeons during concomitant open-heart surgical procedures and during sole-therapy minimally invasive cardiac ablation procedures. During a concomitant open procedure, the surgeon ablates cardiac tissue and/or excludes the left atrial appendage, secondary, or concomitant, to a primary cardiac procedure such as a valve replacement or coronary bypass graft. Additionally, although our products are not indicated

for this specific use, cardiothoracic surgeons have adopted our products to treat Afib patients in sole-therapy minimally invasive surgical procedures. Our Isolator Synergy System, which includes our Isolator® Synergy clamps, an RF generator and related switchbox, is approved by the FDA for the treatment of patients with persistent and long-standing persistent Afib during open-heart concomitant coronary artery bypass grafting and/or valve replacement or repair procedures. To date, none of our other products have been approved or cleared by the FDA specifically for the treatment of other forms of Afib. Additionally, the FDA has not determined that our products are safe and effective for the purpose of reducing the risk of stroke. We anticipate that substantially all of our revenue for the foreseeable future will relate to products we currently sell, or are in the process of developing, which surgeons generally use to ablate cardiac tissue for the treatment of Afib, for the exclusion of the left atrial appendage or for mitral and aortic valve procedures.

Recent Developments

The December 2011 FDA approval of our Isolator Synergy System included the requirement to implement a 350-patient post-approval study (PAS). The PAS trial is designed to evaluate the long-term treatment effect of our Isolator Synergy Ablation System in persistent and long-standing persistent Afib patients undergoing open-heart procedures. We submitted a protocol for the PAS to the FDA in February 2012, and it was approved in September 2012. Approximately 325 patients have been enrolled in the trial. The

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approval also included the requirement to implement a physician training and education program for existing and new users. We submitted a protocol amendment to increase enrollment by up to 40 patients to the FDA in April 2014. The amendment was approved in June 2014.

We are also conducting a Staged DEEP AF Feasibility clinical trial. The Staged DEEP AF Feasibility trial protocol was submitted to the FDA in February 2012. The feasibility trial evaluates the effectiveness of a staged approach, where a minimally invasive surgical ablation procedure is performed initially and a catheter ablation and mapping optimization procedure is performed on a different day during the same hospitalization. FDA approval of the feasibility trial was received in June 2012. Enrollment in the Staged DEEP trial was initiated during the third quarter of 2012 and is complete with 30 patients enrolled at six medical centers. We submitted an Investigational Device Exemption (IDE) for a Staged DEEP Pivotal clinical trial to the FDA in May 2014. The pivotal trial evaluates the safety and effectiveness of a staged approach, where a minimally invasive surgical ablation procedure is performed initially and a catheter and mapping optimization procedure is performed approximately 90 days after the surgical procedure. FDA conditional approval was received in July 2014. We have conditional approval to enroll up to 220 subjects at 23 domestic medical centers and 2 international medical centers.

We are also conducting a Stroke Feasibility clinical trial with the AtriClip System. The Stroke Feasibility trial protocol was initially approved by the FDA in December 2011. An amendment to the protocol was submitted to the FDA and approved in October 2013. The trial evaluates the initial procedural safety and efficacy of the AtriClip System for stroke prophylaxis (i.e., prevention of stroke) in patients with non-valvular Afib in whom long term oral anticoagulation therapy is medically contraindicated. We have approval to enroll up to 30 patients at seven medical centers during the course of the trial. Enrollment began in the first quarter of 2014 and currently stands at four patients.

A provision of The Patient Protection and Affordable Care Act enacted in 2010, as amended (the Affordable Care Act), requires manufacturers of medical devices to pay an excise tax on all U.S. medical device sales beginning in January 2013. We recorded $116 related to the medical device excise tax in cost of revenue during the three months ended June 30, 2014 and $230 during the six months ended June 30, 2014.

On December 31, 2013 we acquired Endoscopic Technologies, Inc. (Estech) by issuing 2,126,343 shares of common stock to shareholders of Estech as consideration and up to $26,000 in additional consideration based on the achievement of certain performance based milestones. The product portfolio acquired includes innovative surgical ablation devices that enable physicians to perform a variety of open concomitant and minimally invasive procedures using Estech s proprietary temperature-controlled RF energy.

Our financial position was strengthened by our public offering of 3,996,250 shares of common stock in January 2013, which generated net proceeds of $26,872. We further strengthened our financial position through a public offering of 3,660,525 shares of common stock in February 2014, which generated net proceeds of $65,830. We believe our current financial position will support the execution of our strategic plan.

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Results of Operations

Three months ended June 30, 2014 compared to three months ended June 30, 2013

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

	Three Months Ended June 30,			
	2014		2013	
	Amount	% of Revenues	Amount	% of Revenues
Revenue	$ 26,514	100.0%	$ 20,429	100.0%
Cost of revenue	7,733	29.2%	5,306	26.0%
Gross profit	18,781	70.8%	15,123	74.0%
Operating expenses:				
Research and development expenses	4,569	17.2%	3,049	14.9%
Selling, general and administrative expenses	17,065	64.4%	13,713	67.1%
Total operating expenses	21,634	81.6%	16,762	82.1%
Loss from operations	(2,853)	(10.8%)	(1,639)	(8.0%)
Other income (expense):				
Interest expense	(29)	(0.1%)	(132)	(0.6%)
Interest income	23	0.1%	2	0.0%
Other	172	0.6%	(17)	(0.1%)
Total other income (expense)	166	0.6%	(147)	(0.7%)
Loss before income tax expense	(2,687)	(10.2%)	(1,786)	(8.7%)
Income tax expense	5	0.0%	5	0.0%
Net loss	$ (2,692)	(10.2%)	$ (1,791)	(8.7%)

Revenue. Total revenue increased 29.8% (28.9% on a constant currency basis) from $20,429 for the three months ended June 30, 2013 to $26,514 for the three months ended June 30, 2014. Revenue from sales to customers in the United States increased $4,449, or 28.8%, and revenue from sales to international customers increased $1,636, or 32.9% (29.1% on a constant currency basis). The increase in sales to customers in the United States was primarily due to increased sales of ablation-related open-heart products of $1,702 and increased sales of the AtriClip system of $1,162. The increase in international revenue was primarily due to an increase in sales in Europe and Asia. Revenue from both the United States and Europe was positively impacted by the addition of products from the Estech acquisition.

Cost of revenue and gross margin. Cost of revenue increased $2,427, from $5,306 for the three months ended June 30, 2013 to $7,733 for the three months ended June 30, 2014. The increase was partially due to approximately $184 in expenses related to the transition of the Estech business. As a percentage of revenue, cost of revenue increased

from 26.0% for the three months ended June 30, 2013 to 29.2% for the three months ended June 30, 2014. Gross margin for the three months ended June 30, 2014 and 2013 was 70.8% and 74.0%, respectively. The decrease in gross margin was primarily due to an increased mix of international sales, which carry lower gross margins, an increase in costs related to the recently-acquired Estech products and increased capital equipment placement.

Research and development expenses. Research and development expenses increased $1,520, from $3,049 for the three months ended June 30, 2013 to $4,569 for the three months ended June 30, 2014. Approximately $165 of the increase was due to expenses related to the transition of the Estech business. The remaining increase in expense was primarily due to a $1,096 increase in product development, regulatory, clinical and quality personnel expense and a $534 increase in clinical trial spending, offset by a $574 decrease in clinical affairs consulting.

Selling, general and administrative expenses. Selling, general and administrative expenses increased $3,352, or 24.4%, from $13,713 for the three months ended June 30, 2013 to $17,065 for the three months ended June 30, 2014. Approximately $593 of the increase was due to transaction, transition and severance expense related to the acquisition of Estech. Approximately $2,662 of selling, general and administrative income was recognized due to the fair value adjustment of the Estech contingent consideration. The remaining increase was primarily due to an increase in sales, marketing and training expenditures.

Net interest expense. Net interest expense for the three months ended June 30, 2014 and 2013 was $6 and $130, respectively. Net interest expense primarily represents amortization of debt issuance costs.

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Other income and expense. Other income and expense consists primarily of foreign currency transaction gains and losses, grant income and non-employee option gains and losses related to the fair market value change for fully vested options outstanding for consultants, which are accounted for as free-standing derivatives. Net other income (expense) for the three months ended June 30, 2014 and 2013 totaled $172 and ($17), respectively.

Six months ended June 30, 2014 compared to six months ended June 30, 2013

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

	Six Months Ended June 30,			
	2014		2013	
	Amount	% of Revenues	Amount	% of Revenues
Revenue	$ 51,361	100.0%	$ 39,859	100.0%
Cost of revenue	14,923	29.1%	10,650	26.7%
Gross profit	36,438	70.9%	29,209	73.3%
Operating expenses:				
Research and development expenses	8,570	16.7%	6,555	16.4%
Selling, general and administrative expenses	38,646	75.2%	26,093	65.5%
Total operating expenses	47,216	91.9%	32,648	81.9%
Loss from operations	(10,778)	(21.0%)	(3,439)	(8.6%)
Other income (expense):				
Interest expense	(266)	(0.5%)	(305)	(0.8%)
Interest income	37	0.1%	6	0.0%
Other	638	1.2%	14	0.0%
Total other income (expense)	409	0.8%	(285)	(0.8%)
Loss before income tax expense	(10,369)	(20.2%)	(3,724)	(9.4%)
Income tax expense	32	0.1%	10	0.0%
Net loss	$ (10,401)	(20.3%)	$ (3,734)	(9.4%)

Revenue. Total revenue increased 28.9% (28.0% on a constant currency basis) from $39,859 for the six months ended June 30, 2013 to $51,361 for the six months ended June 30, 2014. Revenue from sales to customers in the United States increased $7,953, or 26.4%, and revenue from sales to international customers increased $3,549, or 36.3% (32.7% on a constant currency basis). The increase in sales to customers in the United States was primarily due to increased sales of ablation-related open-heart products of $2,958 and increased sales of the AtriClip system of $2,396. The increase in international revenue was primarily due to an increase in sales in Europe and Asia. Revenue from both the United States and Europe was positively impacted by the addition of products from the Estech acquisition.

Cost of revenue and gross margin. Cost of revenue increased $4,273, from $10,650 for the six months ended June 30, 2013 to $14,923 for the six months ended June 30, 2014. The increase was partially due to approximately $375 in expenses related to the transition of the Estech business. As a percentage of revenue, cost of revenue increased from 26.7% for the six months ended June 30, 2013 to 29.1% for the six months ended June 30, 2014. Gross margin for the six months ended June 30, 2014 and 2013 was 70.9% and 73.3%, respectively. The decrease in gross margin was primarily due to an increased mix of international sales, which carry lower gross margins, an increase in costs related to the recently-acquired Estech products and increased capital equipment placement.

Research and development expenses. Research and development expenses increased $2,015, from $6,555 for the six months ended June 30, 2013 to $8,570 for the six months ended June 30, 2014. Approximately $360 of the increase was due to expenses related to the transition of the Estech business. The remaining increase in expense was primarily due to a $2,035 increase in product development, regulatory, clinical and quality personnel expense and a $833 increase in clinical trial spending, offset by a $1,653 decrease in clinical affairs consulting.

Selling, general and administrative expenses. Selling, general and administrative expenses increased $12,553, or 48.1%, from $26,093 for the six months ended June 30, 2013 to $38,646 for the six months ended June 30, 2014. Approximately $2,765 of the increase was due to transaction, transition and severance expense related to the acquisition of Estech. Approximately $2,662 of selling, general and administrative income was recognized due to the fair value adjustment of the Estech contingent consideration. The remaining increase was primarily due to an increase in sales, marketing and training expenditures.

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Net interest expense. Net interest expense for the six months ended June 30, 2014 and 2013 was $229 and $299, respectively. Net interest expense primarily represents interest expense related to amounts outstanding on our term loan, amortization of debt issuance costs and expense related to the payoff of our term loan.

Other income and expense. Other income and expense consists primarily of foreign currency transaction gains and losses, grant income and non-employee option gains and losses related to the fair market value change for fully vested options outstanding for consultants, which are accounted for as free-standing derivatives. Net other income for the six months ended June 30, 2014 and 2013 totaled $638 and $14, respectively.

Liquidity and Capital Resources

As of June 30, 2014 the Company had cash, cash equivalents and investments of $74,588 and short-term and long-term debt of $0, resulting in a net cash position of $74,588. We had unused borrowing capacity of $10,000 under our revolving credit facility. We had net working capital of $75,885 and an accumulated deficit of $132,614 as of June 30, 2014.

Cash flows used in operating activities. Net cash used in operating activities for the six months ended June 30, 2014 was $18,373. The primary net uses of cash for operating activities were as follows:

- the net loss of $10,401, offset by $3,927 of non-cash expenses, including $3,988 in share-based compensation and $2,217 in depreciation and amortization partially offset by $2,662 related to contingent consideration fair value adjustment; and
- a net increase in cash used related to changes in operating assets and liabilities of $11,899, due primarily to the following:
  - an increase in accounts receivable of $1,448, due primarily to an increase in sales during the first half of 2014 as compared to the first half of 2013;
  - an increase in inventory of $2,457, due primarily to increased inventory levels in support of new products and anticipated revenue growth; and
  - a $7,640 decrease in accounts payable and accrued liabilities due primarily to the timing of payments, Estech acquisition expenses and variable compensation payments.

Cash flows used in investing activities. Net cash used in investing activities was $16,048 for the six months ended June 30, 2014. The primary uses of cash in investing activities were $27,322 for purchases of available-for-sale securities and $2,475 related to the purchase of equipment, which consisted primarily of the placement of our RF and cryo generators with our customers. This was partially offset by sources of cash from investing activities of $5,400 in maturities of available-for-sale securities and $8,349 in sales of available-for-sale securities.

Cash flows provided by financing activities. Net cash provided by financing activities during the six months ended June 30, 2014 was $61,501, which was primarily due to proceeds from the sale of stock of $65,830 and proceeds from

stock option exercises of $1,637, partially offset by shares repurchased for payment of taxes on stock awards of $153 and debt and capital lease payments of $6,352.

Credit facility. The Company s Loan and Security Agreement with Silicon Valley Bank (SVB), as amended, restated, and modified (the Agreement) provides for a revolving credit facility under which we could borrow a maximum of $15,000. As of June 30, 2014 we had no borrowings under the revolving credit facility, and we had borrowing availability of $10,000. The applicable borrowing rate on the revolving facility is the prime rate during a Streamline Period and prime plus 1.25% during a Non-Streamline Period, and the revolving credit facility expires on April 30, 2016. The Company repaid the term loan portion of the credit facility in full in March 2014, resulting in $0 outstanding under the term loan as of June 30, 2014.

The Agreement contains covenants that include, among others, covenants that limit our ability to dispose of assets, enter into mergers or acquisitions, incur indebtedness, incur liens, pay dividends or make distributions on our capital stock, make investments or loans, and enter into certain affiliate transactions, in each case subject to customary exceptions for a credit facility of this size and type. Additional covenants apply when we have outstanding borrowings under the revolving credit facility or when we achieve specific covenant milestones. Financial covenants include a limitation on capital expenditures and a minimum liquidity ratio. Further, a minimum fixed charge ratio and a minimum EBITDA apply when specific events occur. The occurrence of an event of default could result in an increase to the applicable interest rate by 3.0%, an acceleration of all obligations under the Agreement, an obligation to repay all obligations in full, and a right by SVB to exercise all remedies available to it under the Agreement and related agreements including the Guaranty and Security Agreement. As of and for the period ended June 30, 2014 we were in compliance with all of the financial covenants of our amended and modified credit facility. In addition, if the guarantee by the Export-Import Bank of the United States ceases to be in full force and effect, we must repay all loans under the Export-Import agreement.

We have an outstanding letter of credit of 75 issued to our European subsidiary s corporate credit card provider which will expire on June 30, 2015.

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

In July 2011 we filed a shelf registration statement with the SEC which allows us to sell any combination of senior or subordinated debt securities, common stock, preferred stock, warrants, depositary shares and units in one or more offerings should we choose to do so in the future. In January 2013 we sold approximately 3,996,250 shares of common stock under the shelf registration which resulted in net proceeds of approximately $26,872.

In January 2014 we filed a shelf registration statement with the SEC which allows us to sell any combination of senior or subordinated debt securities, common stock, preferred stock, warrants, depositary shares and units in one or more offerings should we choose to do so in the future. In February 2014 we sold 3,660,525 shares of common stock under the shelf registration which resulted in net proceeds of approximately $65,830.

We believe that our current cash, cash equivalents and investments, along with the cash we expect to generate or use for operations or access via our revolving credit facility, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months. If our sources of cash are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or obtain a revised or additional credit facility. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights senior to those associated with our common stock and could contain covenants that would restrict our operations. Additional financing may not be available at all, or in amounts or terms acceptable to us. Finally, our credit facilities require compliance with certain financial and other covenants. If we are unable to obtain this additional financing, we may be required to reduce the scope of our planned research and development, clinical activities and selling and marketing efforts.

Off-Balance-Sheet Arrangements

As of June 30, 2014 we had operating lease agreements not recorded on the Condensed Consolidated Balance Sheets. Operating leases are utilized in the normal course of business.

Seasonality

During the third quarter, we typically experience a decline in revenue that we attribute primarily to the elective nature of the procedures in which our products are used. We believe this is due to fewer people choosing to undergo elective procedures during the summer months.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses, and disclosures of contingent assets and liabilities at the date of the financial statements. On a periodic basis, we evaluate our estimates, including those related

to sales returns and allowances, accounts receivable, inventories and share-based compensation. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from those estimates under different assumptions or conditions. Our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 includes additional information about the Company, our operations, our financial position, our critical accounting policies and accounting estimates and should be read in conjunction with this Quarterly Report.

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of June 30, 2014 there were no material changes to the information provided under Item 7A-Quantitative and Qualitative Disclosures About Market Risk in the Company s Form 10-K for the year ended December 31, 2013.

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Item 4. Controls and Procedures

Disclosure Controls and Procedures

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

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

Changes in Internal Control Over Financial Reporting

In the ordinary course of business we routinely enhance our information systems by either upgrading current systems or implementing new ones. There were no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

In addition to the other information set forth in this report, careful consideration should be given to the factors discussed in Part I, Item 1A. Risk Factors in our Form 10-K for the year ended December 31, 2013, all of which could materially affect our business, financial condition or future results. The risks described are not the only risks facing us. Additional risks and uncertainties not currently known to us, or that we currently deem to be immaterial, also may adversely affect our business, financial condition and/or operating results. There have been no material changes with

respect to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.

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Item 6. Exhibits

Exhibit No.	Description
31.1	Rule 13a-14(a) Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Rule 13a-14(a) Certification of Principal Accounting and Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350 by the Principal Executive Officer, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 U.S.C. Section 1350 by the Principal Accounting and Financial Officer, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

AtriCure, Inc.
(REGISTRANT)

Date: July 30, 2014

/s/ Michael H. Carrel
Michael H. Carrel
President and Chief Executive Officer

(Principal Executive Officer)

Date: July 30, 2014

/s/ M. Andrew Wade
M. Andrew Wade
Vice President and Chief Financial Officer

(Principal Accounting and Financial Officer)

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